



**RIGA  
GRADUATE  
SCHOOL OF  
LAW**

# **Permanent Establishment in Corporate Taxation in the Digital Era.**

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## **BACHELOR THESIS**

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### **DECLARATION OF HONOUR:**

I declare that this thesis is my own work, and that all references to, or quotations from, the work of others are fully and correctly cited.

(Signed).....

RIGA, 2020

## **ABSTRACT**

Digital economy has significantly grew in the past 15 years, and currently it already accounts for more than 50 percent of the whole market capitalization worldwide. There is no longer a need for physical place to generate profits from the particular jurisdiction if business activity is digital.

Nonetheless, the international taxation rules of allocating taxation rights for business profits to non-resident jurisdiction has not changed in way to tackle substantial economic presence, without fixed place of business. Thus, resulting in harmful use of permanent establishment principle for tax planning purposes, which has led to profit shifting away from the high-tax jurisdiction to low-tax jurisdictions and also not fairly allocating rights between related jurisdictions, in particular causing loses for market jurisdictions.

To answer the arising challenges from digital economy OECD/G20 under the new BEPS project are creating new nexus rules with regards to digital economy, moreover they have also placed a focus on solutions for already existing issues under the current set of rules, under BEPS Action 7. The support for changes can also be seen through European Commission proposals for council Directives and interim measures within different domestic laws. Nonetheless, global issues ask for global solutions, thus to properly create new nexus rules, it asks for international solution, for the sake of certainty and unnecessary negative impact on the global economy.

This thesis analyzes the issues currently arising from application of permanent establishment principle to digital enterprises and pays attention to possible solutions and outcomes under new nexus rules taking into account work done so far and trends to which development is leaning to.

## SUMMARY

The way of doing business has significantly changed starting from an early 21<sup>st</sup> century due to opportunities provided by the growth of digital era and most importantly people interaction with it. This has allowed business to scale and access the markets without large investments in premises, machinery or labor force. To certain extent the importance of tangible assets, has significantly reduced due to the changing environment, variety of outsource option and new kind of business models worldwide. Simplicity and access to such business models are creating value not only to consumers or enterprises, but also involved states, since as the growth and exports also contribute and positively reflect to the economy growth.

Nonetheless, the rapid growth of the online commerce with new types of business models and low-barriers to enter reach wide consumer base worldwide, has created certain issues from the perspective of effective and fair regulations worldwide. Since as, current rules in place were created to tackle issues for regular, known business models, such as “brick and mortar”, not “click-mortar” business models<sup>1</sup>. Most importantly, for the involved economies is the income and profits which are generated within their geographical location, since as maintenance of the infrastructure is a cost to the government, incomes arising from the activities in their market is the way how they are able to compensate it.

To continue, current rules in place internationally has not changed as rapid as the growth is happening, thus variety of issues are arising exactly from the standpoint that current rules does not sufficiently cover the digital economy, which has resulted in lower tax burdens and ability to use gaps in the current system to plan or avoid certain taxation rules. This is the exact case of allocation of taxation right for business profits under the current permanent establishment rules, which explicitly creates a need for changes to properly tackle issues arising from current application.

First chapter of this thesis, covers the development of the current permanent establishment principle and its rules under OECD Model Tax Convention and UN Double Taxation Convention, which serves as the main guideline for bilateral treaty conclusion, thus having an important role in international doublet taxation. Analysis covers the current application procedure for the overall global economy.

Second chapter, deals with the current application interpretation and procedure for digital enterprises, covering currently arising issues of permanent establishment application, with regards to both, a tax payer and a tax administration. Moreover, it also looks upon why such application creates unfair allocation rights and how does it comply with general ideology of permanent establishment principle in the light of compliance with origin of wealth as a basis for rise of taxing rights.

Lastly, third chapter provides the analysis of how the new nexus rules are developed so far under OECD Inclusive Framework, pillar one and what must be also taken into account in further creation of the new nexus rules, by looking at EU Directive proposals, intra-national domestic approach to the economic significant presence and concerns raised by Giammarco

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<sup>1</sup> *Brick-mortar is business model where entity is located in physical place from which business activity is conducted, for instance, retail shops. Click-mortar is business model which is conducted through digital means,*

Cottani, who is Global Tax Policy Director at Mega Multinational Enterprise – Netflix, with 20 billion USD turnover in 2019 and 65 million subscribers with more than 100 million users and he also is international tax law researcher involved in OECD BEPS project development as a delegate from Italy. Analysis are placing focus on the issue questions, which currently has not been addressed yet and which might negatively affect economy.

In the conclusion, paper summarizes the current permanent establishment application to digital enterprises, whereas continues with following issues arising from such application from the company and governments perspective. Afterwards, looks at the possible solutions and work done so far for the creation of international approach of new nexus, which currently has developed in six step test, however the last step, which is new nexus, has not been developed yet. Thus authors covers already existing approaches in the EU proposals and interim measures by Israel and India, to guide through the possible outcomes. These findings provide a potential four main concerns of the new nexus, which in authors opinion, should be worth to reconsider before the implementation of the new nexus rules on international level not to cause negative effect on the real economy and also to create fair and effective mechanism for the digital economy.

**Key words:** *permanent establishment, digital economy, significant digital presence, new nexus rules, CCCTB, significant economic presence, business profit taxation, allocation of taxing rights, OECD, G20, BEPS*

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## **LIST OF ABBREVIATIONS**

PE	Permanent Establishment
CIT	Corporate Income Tax
IFA	International Fiscal Association
OECD	Organization for Economic Co-operation and Development
EU	European Union
VAT	Value Added Tax
UN	United Nations
TAG	Technical Advisory Group
PwC	PricewaterhouseCoopers
CCCTB	Common Consolidated Corporate Tax Base
SDP	Significant Digital Presence
MLI	The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
PPE	Plant, Property and Equipment
MNE	Mega Multinational Enterprise
LME	Large Multinational Enterprise
SME	Small-Medium Multinational Enterprise
IBFD	International Bureau of Fiscal Documentation
MDTC	Model Double Taxation Convention
G20	Group of Twenty
USD	United States Dollar

## INTRODUCTION

“National tax policy is one product of the classic Lockean social contract between individuals and government. But countries are now so economically interdependent that one nation’s tax policies can profoundly undermine another’s.”<sup>2</sup>

Taxation for countries is an essential instrument for maintaining the infrastructure of the whole state, including social, environmental, educational, and healthcare and many more industries that ask for monetary contribution by state, which is reached through taxation system between tax payers and s government within the particular economy through direct or indirect taxes. Moreover, current situation with taxation has gone beyond merely national level of the social contract between both sides. These are the consequences, arising from the trend of globalization and country-by-country synergy, which results in economic growth on the global scale, from the perspective of available opportunities for the companies, which reflects positively to economic growth of the each country separately. It is important to acknowledged that digital enterprises in the pasts 15 years, has grew rapidly, from 7 percent to 54 percent market capitalization<sup>3</sup>, thus its importance on the global scale has also importantly grew.

Together with opportunities for economic cooperation and ability to access new markets through digital means, new threats are arising exactly from the perspective of relatively unknown issues. To continue, digital enterprises are being taxed with significantly lower effective average rate, accounting for approximately 10 percent, while regular business models are having an effective average tax rate of 23 percent<sup>4</sup>. One of challenges is fair and effective allocation of taxing rights between jurisdictions exactly for multinational enterprises. Moreover, it can be seen that changes are happening, but currently seems that the focus is placed more on the changes in indirect taxation system, more specifically Value Added Tax (hereinafter referred to as “VAT”) fraud issues. While direct taxes to certain extant is not developing as rapid as the economic changes are happening exactly in digital economy. One of such direct taxes is Corporate Income tax (hereinafter referred to as “CIT”), which approximately accounts for 13 percent of all tax revenues among OECD countries<sup>5</sup>.

CIT covers business profit taxation, which is based on residence principle, meaning that companies are taxed were they have their residence, unless there is an existence of permanent establishment (hereinafter referred to as “PE”) in contracting state, thorough bilateral or multilateral treaty<sup>6</sup>. Bilateral treaties are built on the guidelines of two main

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<sup>2</sup> A. Chirstians, “Sovergnity, Taxation, and Social Contract”, (2018), available on: [https://www.researchgate.net/publication/228135833\\_Sovereignty\\_Taxation\\_and\\_Social\\_Contract](https://www.researchgate.net/publication/228135833_Sovereignty_Taxation_and_Social_Contract), accessed: 30.04.2020

<sup>3</sup> Infra 33

<sup>4</sup> ZEW. “Effective Tax Levels Using the Devereux/Griffith Methodology: Final Report 2016”, available on: <https://www.zew.de/en/publikationen/effective-tax-levels-using-the-devereuxgriffithmethodology-final-report-2016/>. Accessed 30.04.2020.

<sup>5</sup> Infra 121

<sup>6</sup> L. A. Steenkamp, “The Permanent Establishment Concept In Double Tax Agreements Between Developed And Developing Countries: Canada/South Africa As A Case In Point”, *International Business & Economics Research Journal*, (2014), available on: [https://www.researchgate.net/publication/261913389\\_The\\_Permanent\\_Establishment\\_Concept\\_In\\_Double\\_Tax\\_Agreements\\_Between\\_Developed\\_And\\_Developing\\_Countries\\_CanadaSouth\\_Africa\\_As\\_A\\_Case\\_In\\_Point](https://www.researchgate.net/publication/261913389_The_Permanent_Establishment_Concept_In_Double_Tax_Agreements_Between_Developed_And_Developing_Countries_CanadaSouth_Africa_As_A_Case_In_Point), accessed: 30.04.2020



international double taxation conventions, OECD Model Tax Convention and UN Double Taxation Convention. Rules, thus playing an important role within international taxation field, combating double taxation issues and reaching fair allocation of rights, moreover to combat new issues arising on global level, must also be fixed on the global level with coordinated actions by international forum. Historically PE principle has its traces back in 19<sup>th</sup> century, which afterwards has developed as main internationally recognized and accepted principle for allocating business profit taxing rights (also known as “nexus rules”) between jurisdictions where enterprises are acting in more than one jurisdiction, called multinational enterprises.

The basis and general idea of this principle is that company must have significant physical presence at the jurisdiction, through fixed place. Nonetheless, digitalization has created situation where significant economic presence can be reached by not being physical present at the particular location. Thus creating situation, where some market jurisdictions does not have any rights of business profit taxation duly to the fact that current PE principle does not recognize such approach. Also it gives a rise of intentional avoidance for establishing PE in high-tax jurisdictions or on the other hand establish PE in low-tax jurisdictions, through gaps left and not covering digital enterprises.

Nonetheless, EU commission and OECD/G20 has raised new initiatives to combat these issues, creating new nexus rules. For that reason it is important to understand the current flaws in details to properly tackle them by the new nexus rules establishing significant presence without physical presence. Finally understanding the topics significance, the new approach must be evaluated from the perspective of transitional and conceptual issues, to understand the possible outcome and effect on the real economy. Also, it is proposed to be finished by the end of 2020, so it is topical question of how it should look, moreover what is the trend to which it is going and what issues might thus appear or must be reconsidered before finishing the new rules.

### **Research Questions:**

1. How current PE rules are applied to digital enterprises, what issues does it create for governments and enterprises?
2. How possibly new nexus rules will conceptualize on the international level, what problems it might cause?
3. What suggestions and proposals may be drawn from the analysis for new nexus development?

### **Methodology**

This paper is based on qualitative and quantitative analysis of existing primary law and proposals by OECD/G20 BEPS project, changes under Pillar One and EU proposals for Council Directives, as well including expert opinions. Moreover, also paper included empirical research, whereas author conducted interview with Giammarco Cottani, Tax Policy Director of the company Netflix and international tax law researcher also involved in OECD BEPS project as a delegate from Italy, on the relevant and upcoming issue question of the PE principle.

## **1. Historical Overview and Legal Status of Permanent Establishment Concept**

Within development and globalization issues regarding fair and proportional taxation between different jurisdictions where one enterprise is involved, mainly were solved by the idea that profits are taxed at the place where the business enterprise is physically located. If this enterprise has multiple physical locations, profits must be allocated between jurisdictions based on where the value creation has happened, meaning that each jurisdiction would get the part of the tax revenues on profits, which were generated within particular country. Therefore, application of PE would grant taxing rights for income source states on foreign companies<sup>7</sup>, even though this concept seems mainly to benefit and be in favour for the state, which might claim the tax revenues, there is also way around for companies, which might also be interested to be taxed at the specific jurisdiction for the sake of lower tax burden.

Interpretation of PE raises questions regarding digital business enterprises, since in such cases place of establishment is not fixed within a specific location. It creates uncertainty of the profit attribution to the states. Following section will look upon the interpretation of what exactly must be understood as existing PE under International Conventions currently in place, such as the OECD Model Tax Convention on Income and Capital and UN Model Double Taxation Convention.

### **1.1. Allocation of taxing rights of non-residents on Business profit taxation**

Both OECD Model Tax Conventions and UN Model Tax Convention in Article 7 describe taxable business profits, however, there is no clear definition of what must be understood as profits under the Convention. As it was given in commentary of OECD Model Tax Convention paragraph 71.<sup>8</sup>

Profits must be understood in the broad meaning within the Convention, however, within application domestic laws of the MS would clarify the meaning of the term profits. This is mainly due to differences within the domestic taxation systems, since as taxable base within which notion of income and expenses might slightly differ due to the overall system, which might be based on the specific jurisdiction strategy to gain main tax revenues from indirect taxes or direct taxes<sup>9</sup>. Within this paper author, will look at the business profits from the broad sense, not going into details of the interpretation.

The general rule of the taxation of business profits is stipulated under Article 7. (1) of both Conventions, saying that profits must only be taxed at the jurisdiction where enterprise is resident, if it has PE in different jurisdiction, taxable profits are only the ones which are attributed to that specific PE. Paragraph 2. of the Article 7 of the OECD Model Tax

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<sup>7</sup> OECD, "OECD Model Tax Convention: Revised proposals concerning the interpretation and application of article 5 (permanent establishment)", (Paris, 2013), available on: <http://www.oecd.org/ctp/treaties/PermanentEstablishment.pdf>, accessed: 11.03.2020

<sup>8</sup> OECD, OECD Model Tax Convention (Condensed Version), (2017), p. 195 available on: [https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017\\_mtc\\_cond-2017-en#page195](https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page195), accessed on: 09.03.2020

<sup>9</sup> Alexandre Rust, "Business' and 'business profits", *EC and International Tax Law Series, Vol. 7.* (Amsterdam: 2017), available on: [https://www.ibfd.org/sites/ibfd.org/files/content/pdf/meaning\\_of\\_enterprise\\_sample.pdf](https://www.ibfd.org/sites/ibfd.org/files/content/pdf/meaning_of_enterprise_sample.pdf), accessed: 09.03.2020

Convention points out that criteria to determine what profits are attributed to the specific jurisdiction, determination mainly depends on economic reality and the factual circumstances, which must be done to determine the part of the taxable profits attributed to the specific PE<sup>10</sup>.

Concluding, Article 7. points out two main rules, first that enterprise can only be taxed on business profits at the place where it has its PE, second if it has PE elsewhere, particular state may be entitled to tax the profits solely attributed to that specific PE<sup>11</sup>. Resulting in the main question, what criteria is currently in place to determine existence of PE, moreover, it must be understood how historically PE as a concept has developed to apply it in a way it was designed to be applied.

## **1.2. Overview of historical development of Permanent Establishment Concept**

Interpretation of Tax Treaty provisions also including principle of permanent establishment, has two kinds of opinions in place, which were covered in IFA Conference on Tax Treaty History in 2004<sup>12</sup>. In discussion between David A. Ward (1931-2010), who was leading executive of Canadian branch and researcher, who has significantly contributed with the ideas to overall international and domestic tax law system<sup>13</sup> and Joel Nitikman (1961 – present), who was also Canadian Tax specialist, with Education in Taxation, University of British Columbia, University of Manitoba and New York University<sup>14</sup>. Whereas discussion was made from mainly two sides of the story. In Wards opinion, historical development and history itself has little or no value of the interpretation of the Tax Treaties, following the fact that interpretation in case of active litigation, will mainly be based on the OECD Model Tax Conventions approach and commentaries regarding the application of the rules at the current time in place. On the other hand Nitikman, with support of Richard Vann, who currently is researcher and until 2013 was a member of Permanent Scientific Fiscal Association<sup>15</sup>. argued that there are so little case law or actual practice in place, that the right way of application of articles to some extent are dependent on historical interpretation method, referring to the case of Cudd Pressure, where court referred to the League of Nations work in 1920s in order to interpret 1942 tax treaty between Canada and US<sup>16</sup>. Evaluating the impact of the history to interpretation of OECD Model Tax Convention rules through both perspectives, history within interpretation is left more as theoretical approach existing in court system, which is not practically often used. Author will look up on the historical development, firstly due to the fact that even though it is not frequently used in court practice, it might have an importance and it might be also raised in litigation process, secondly to later on understand how and to

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<sup>10</sup> Supra note 7, p. 180

<sup>11</sup> Supra note 6

<sup>12</sup> Infra note 15

<sup>13</sup> M. Guglielmo, "Essays on Tax Treaties: A Tribute to David A. Ward", *IBFD*, (2020), available on: <https://www.ibfd.org/IBFD-Products/Essays-Tax-Treaties-Tribute-David-Ward>, accessed: 09.03.2020

<sup>14</sup> Dentons, "Joel A. Nitikman", *dentons.com*, (2020), available on: <https://www.dentons.com/en/joel-nitikman>, accessed 09.03.2020

<sup>15</sup> IBFD, "Richard J. Vann", (2020), available on: <https://www.ibfd.org/IBFD-Profiles/Richard-J-Vann>, accessed: 07.05.2020

<sup>16</sup> L. Friedlander, S. Wilkie, "Policy Forum: The History of Tax Treaty Provisions – And Why It Is Important To Know About It", *Of Osler Hoskin & Harcourt LLP, Toronto, Vol. 54, No 4*, (2006) available on: <https://www.uni-heidelberg.de/institute/fak2/mussnug/historyoftaxdocuments/schrifttum/aufsaeetze/AUFS00020.pdf> accessed on:

15.03.2020

what direction general trend is moving regarding development of the PE concept in international instruments.

### 1.2.1. Physical Presence as a core from Early Development

PE as a concept, has its roots back in the middle of 19<sup>th</sup> century in between Prussia and Saxony concluded Tax Treaty, it did not mention PE as concept, however it recognized two main conditions for limitations of the source-state taxation, one of them was fixed place<sup>17</sup>.

Afterwards in early 20<sup>th</sup> century, Germany enacted Double Taxation Act of 1909, to exclude possibility of double taxation between German states, which did look upon PE from the broad perspective mainly looking at this concept from the business activity test perspective<sup>18</sup>. By developing international relations regarding international trade before World War I, the concept within Austrian-Czechoslovakia and Germany-Czechoslovakia Tax Treaties was recognized similar to Prussian approach, which entailed terms as “Industrial establishment”, “business establishment” or “establishment”, which created main approach of having fixed place for business. This was recognized within Anglo-Saxon treaties<sup>19</sup>, with slight differences of recognition of agents.

The most rapid changes within international context of taxation came after World War I and the establishment of League of Nations. It was a major step towards more integrated and focused international community towards trade in general. Beforehand, trade was focused on intra-state level, between empires. After League of Nations, the overall focus shifted from this intra-state level to international scope to create uniform rules and guidelines. One of the issues League of Nations tried to tackle was double taxation rules between countries, where also PE concept appeared in 1925 report of the Convention for the Prevention of Double Taxation<sup>20</sup>, with comments regarding interpretation of rules stipulated within convention. PE as a principle has been codified in Article 5, mainly pointing three key elements, firstly, what must be understood as a permanent establishment. Secondly, agent being as a PE. Thirdly, the concept of the source-state which is entitled to the portion of tax revenues on income produced within this state.

Report of by Committee of Technical Experts on Double Taxation and Tax Evasion in 1925, within its commentaries regarding Article 5 (permanent establishment) of the Convention for the Prevention of Double Taxation, mentions that second paragraph of the Article, which points out what must be regarded as PE, states that it must be understood as:

“..real centers of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, **no matter whether such establishments** are used by the traders themselves, **by their partners**, attorneys, or their **other permanent representatives**.”<sup>21</sup>

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<sup>17</sup> B. Walker, “The evolution of the Agency Permanent Establishment Concept”, (2018), available on: <https://www.business.unsw.edu.au/About-Site/Schools-Site/Taxation-Business-Law-Site/Documents/40-Walker-ATTA2018.pdf>, accessed: 10.03.2020

<sup>18</sup> Ibid

<sup>19</sup> Supra note 17

<sup>20</sup> Committee of Technical Experts on Double Taxation and Tax Evasion, “Double taxation and tax evasion report”, (1927), Geneva, available on: [https://biblio-archive.unog.ch/Dateien/CouncilMSD/C-216-M-85-1927-II\\_EN.pdf](https://biblio-archive.unog.ch/Dateien/CouncilMSD/C-216-M-85-1927-II_EN.pdf), accessed: 10.03.2020

<sup>21</sup> Supra note 20. p. 15

Which seems that PE must be held by the company in question, however it also can be concluded that there is existence of PE through their partners or other permanent representatives. How to interpret such PE which is held by partner in case of imaginary situation of digital enterprise in the time of existence of such provision? Currently one digital enterprise, which sells physical goods may have partner in Malta holding the servers and webpage platform; partners in China, who are producing, fulfilling and shipping out orders. Creating list of connected actions, which would mean that by taking out one process, company would not be able to perform its economic activity. The question in such case still remains existing, since as by expert commentaries, there seems to be actual ability to establish PE based on partner activities, also from the perspective of the concept of the source state, these places should be entitled to claim its tax revenues on the income produced by such digital enterprise. On the other hand effective and real management does not happen within servers in Malta, so there is no other value created, however without it company would not exist. Under these provisions it is not clear how to balance out effective and real management and value creation with essential processes within company's whole existence

Approach of historical development within PE concept has differed slightly because of different interpretation of independent and dependent agent understanding under Anglo-Saxon and Civil law jurisdictions. After establishment of League of Nations, PE concept was codified based on two pillars of ideas, firstly fixed place of business as main principle for existence of PE, secondly granting taxing rights based on source state principle. Broad and wage opinion by commentaries of the Article 5 of the Convention on Double Taxation and Tax Evasion, creates even higher uncertainty of possible application of PE through partner companies and other permanent representatives, since as they are mentioned within Conventions.

### **1.3. Application of OECD Model Tax Convention and UN Model Double Taxation Convention**

United Nations Model Double Taxation Convention is a result of historical development through League of Nations. First publication and adoption of this convention was in 1980, Convention was developed because of globalization, trade increase internationally and investment inflows in developing countries from developed countries. It was an instrument setting out guidelines for bilateral treaties concluded by both parties on double taxation<sup>22</sup>. Convention was updated 19 years later and published in 2001, which led to 2017 updated version which took 4 years of development and changing of organizational structure. Both conventions are applied and used as a guide for country-by-country bilateral treaties on Double Taxation rules, thus both conventions plays important role in overall international taxation system.

General concept of business taxation based on PE principle has experienced minor changes are minor and can be seen under Article 5 of UN MDTC<sup>23</sup>, which starting from first edition of this Convention, has now narrowed down the concept of the PE regarding different industries, which are *ad hoc* cases of PE interpretation and application. Article 5 of UN

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<sup>22</sup> Department of Economic & Social Affairs, "United Nations Model Double Taxation Convention between Developed and Developing Countries 2017 Update", (2017), New York, available on: [https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT\\_2017.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf), accessed: 12.03.2020

<sup>23</sup> *ibid*

Convention, is mainly based on OECD Model Tax Conventions approach which has changed and updated almost year on year bases in late 20<sup>th</sup> century. It can be speculated that both Convention are almost equal regarding their interpretation of PE with small exceptions, which would place lesser burden for countries on bilateral treaties if UN Model Convention is applied, for instance, for building sites time period in OECD is 12 months<sup>24</sup> to be considered as PE, under UN it is 6 months, which therefore gives opportunity to claim tax revenues on income attributed to the building site faster. Otherwise the interpretation of Article 5 is based on the same commentaries OECD article 5 (Permanent Establishment) is based upon. Author within its work will only look from the perspective of OECD Model Tax Convention and actions plans developed by OECD because of interdependency regarding PE as a concept and its application, with few exceptions where rules may differ and influence the PE application for e-commerce enterprises.

### **1.3.1.OECD Model Tax Convention**

Latest 10<sup>th</sup> edition of OECD Model Tax Convention with its commentaries has been published in 2017, the whole convention is constantly reviewed and amended for the main purpose to tackle new taxation issues to prevent double taxation and tax evasion and also to promote and codify measures under OECD/G20 Base Erosion Profit Shifting action plans. Through this Convention, OECD is able to tackle issues under Action 2, Action 6, Action 7 and Action 14<sup>25</sup>.

#### **1.3.1.1.Conditions of Place of business existence**

Article 5 and commentaries sets out main conditions, which must be met to conclude that there is an existence of PE. The key elements of the PE, has not changed since 1977. Convention still emphasizes the importance of fixed place of business, which is stipulated under paragraph 1, also saying that it must entail certain degree of performance<sup>26</sup> and that this fixed place of business must have certain degree of permanency. However essential part of the interpretation of the existing place of business it within paragraph 10 of the commentaries on Article 5, paragraph 1, which says:

The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installation are owned or rented by or are otherwise at the disposal of enterprise<sup>27</sup>.

Which to some extent diminishes the essence of the principle of fixed place, putting the focus on the effect of the PE through perspective of existence through “at disposal of” effect. Existence of PE through concept of “at disposal of” should be evaluated through enterprises

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<sup>24</sup> Supra note 7. p. 31

<sup>25</sup> OECD, “About OECD Model Tax Convention on Income and on Capital: Condensed Version 2017”, (2017), Paris, available on: <https://www.oecd.org/ctp/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm>, accessed: 14.03.2020

<sup>26</sup> Department of Economic & Social Affairs, “United Nations Model Double Taxation Convention between developed and Developing Countries”, (2014), New York, available on: <https://www.un.org/esa/ffd/wp-content/uploads/2014/09/DoubleTaxation.pdf> accessed: 14.03.2020

<sup>27</sup> Ibid, Para 10

effective power through this location, which must take into account all relevant circumstances, the fact that it is at the disposal of the enterprise, would not automatically mean that there is an existence of PE in particular location, also paragraph 4 of the Article 5 must be taken into account, because it sets out what actions by enterprise shall not give a rise of PE existence, even though through concept of at disposal of enterprise would grant PE<sup>28</sup>.

Commentaries expand the interpretation of paragraph 1, continuing to point out that the performance must happen through some dependent personnel in that state where fixed business is located. For the purpose to attribute profits to the specific PE, commentaries raise the idea that the PE must be of the “productive character”, which however has a lost its historical importance. It is a tool which contributes to the proper attribution of profits to the specific PE and to the specific jurisdiction which must be evaluated through the circumstances of the case in particular time, since business activities evolve over time, which would mean that application of the paragraph 1 in practice can be widened in case of its application. It is up to the domestic laws, of how to approach specifics.

Another concept which widens application of paragraph 1, is “at disposal of” test, which does not explicitly appear in the lines of Article 5, but it appears in the commentaries of the OECD convention, pointing out that place of business can also constitute PE, if this place is at the disposal of enterprise. “At the disposal of” test, mainly depends on circumstances of case, but the idea entails, that such activity must be of a permanent nature and includes substantive part performed of business activity<sup>29</sup>. Test continues with the fact that legal form and status of the particular premises, installations or personnel is not of significant matter, meaning that the particular thing at the disposal of enterprise may also be illegally occupied or managed by the enterprise and it still would constitute PE, thus it is of a question whether the particular thing or location is at the exclusive right to use of the enterprise<sup>30</sup>.

#### **1.3.1.2. Non exhaustive list of activities, which must be regarded as PE.**

Paragraph 2 and 3 are less of an importance for application to digital enterprises, however they sets out certain rules which must be read together with Article 5 of the Convention.

Paragraph 2, sets out what must be understood as PE, including a list of six elements, regarded as PE, them being: a place of management, a branch, an office, a factory, a workshop and places of extraction of natural resources. According to commentaries this list is not an exhaustive and it must be read together with all paragraphs of the Article 5.

Paragraph 3 is in place for construction sites and installation projects, which states that they can only be regarded as PE in case if they lasts longer than 12 months. In the case of UN Model Double Taxation Convention, was reduced to six month period.

#### **1.3.1.3. Preparatory and auxiliary activity as a factor, which denies existence of PE.**

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<sup>28</sup> Supra note 22., Paras. 10-13

<sup>29</sup> OECD, “Interpretation and application of article 5 (permanent establishment) of the OECD Model Tax Convention”, (2012), available on: <http://www.oecd.org/tax/treaties/48836726.pdf>, accessed: 11.04.2020

<sup>30</sup> Committee of Experts on International Cooperation in TaxMatters, “Proposed Guidance on Permanent Establishment in the Extractive Industries”, (2016), New York, available on: [https://www.un.org/esa/ffd/wp-content/uploads/2016/12/13STM\\_CRP22\\_Extractives\\_PEs.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2016/12/13STM_CRP22_Extractives_PEs.pdf), accessed: 11.04.2020

Paragraph 4 sets out exceptions to permanent establishment principle, listing when a particular situation should not be regarded as permanent establishment. The main idea of the exceptions of PE is that, there are certain activities, which are physical fixed places, however because of their character, they should not be regarded as PE due to the fact that for economic activity they are either preparatory or auxiliary. To understand how preparatory or auxiliary should be applied and regarded, commentaries which says that the condition of activity to be regarded as such, is based on answer whether the activity of the fixed place for business is of an essential and significant part of the whole business. Preparatory means that particular action is done beforehand to prepare for the main business activity, for example, educating employees, and auxiliary character means that it supports the main activity but is not essential part of this activity. If business enterprise is able to work properly without the particular activity, it must be regarded as auxiliary. Regarding paragraph 4 states are able to either reduce limits by paragraph 4 or increase them, therefore in many circumstances the interpretation of paragraph 4 would vary from state to state<sup>31</sup>.

Paragraph's 4.1. main aim is to prevent group of companies or related companies to artificially divide whole business activity in smaller parts. To apply paragraph 4.1. it is necessary that there is an actual existence of PE and that the particular entity is a part of the group or is closely related to the company which is also situated in the same place and it fulfils complementary function for the whole cohesive business operations<sup>32</sup>.

#### **1.3.1.4. Dependent and Independent agent importance to determine existence of PE.**

Paragraphs 5 and 6 of OECD Model Tax Convention sets out the differences when there is an existence of PE through agent and when it shall be considered that the PE does not exist. It sets out criteria for dependent agent (paragraph 5) and independent agent (paragraph 6).

Dependent agents are regarded as persons, who acts on behalf of the company, it does not matter whether it is a company, employee or just an individual, which do not perform its tasks and activities as independent agent. Three main criteria according to commentaries, has been set, firstly person must act on behalf of the enterprise, meaning the person must have a direct or indirect effect on the enterprise, secondly action must be in a way that this person is habitually able to conclude contract or it plays principle role in conclusion of contracts without modifications by the enterprise. Thirdly, these contracts must be in the name of the enterprise or concluded so that the enterprise receives the ownership or has the right to use the object in question. Even if all the conditions are met, paragraph 5 should not cover specific issues<sup>33</sup>.

Moving to paragraph 6, which sets out that PE granted under paragraph 5, must be non-existent, if the person in question is responsible for certain work or outcome upon which this person has no or has only little control. This is a test of entrepreneurial risks and conduct of the business in the real economic terms, for which the particular person receives a reward<sup>34</sup>.

#### **1.3.1.5. Rules on subsidiaries and related persons, within PE context**

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<sup>31</sup> Supra note 22, para 77 - 78

<sup>32</sup> Supra note 22, para 79 - 81

<sup>33</sup> Supra note 22, pp. 141 – 146

<sup>34</sup> Supra note 22, pp. 146 -150



Article 5(7) sets out the general rule - the fact of the existence of subsidiary, does not constitute PE, nonetheless it may constitute if particular subsidiary falls under conditions of paragraph 1 or 5 of this Article, meaning, subsidiary must be regarded as a separate legal entity. If the company is at direct disposal of mother Company, it is still important to take into account the existence of independent agent, since, according to the commentaries, subsidiary may provide services to the mother company, with its own personnel and on the same hand provide services to others. In such case the concept should not be regarded as PE for the mother company, merely because the services are provided for related person. Furthermore, paragraph 8 stipulates, what must be considered as related person for the interpretation within Article 5<sup>35</sup>.

#### **1.3.1.6. Important difference between UN and OECD approach regarding service providers as a factor for existing PE.**

Overall the application of UN and OECD approach for PE concept in broad terms is the same, due to interdependency of rules and commentaries expressed under UN's approach regarding PE. The major difference is that, where OECD rules do not specifically mention the existence of PE within such circumstances<sup>36</sup> and it may play an important role of interpretation and application of PE concept to e-commerce companies<sup>37</sup>. This difference is within paragraph 3. of Article 5 of UN Model Double Taxation Convention:

“The term “permanent establishment” also encompasses: ...(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.”<sup>38</sup>

Meaning that different service providers may be regarded as a PE, for specific enterprise if they, do provide them for 6 months or more within any 12-month period. This is so called physical presence test. Such provision, does not exist within OECD Model Tax Convention, the approach of application is also blurry. Within scope of commentaries and reports done by Technical Advisory Group (hereinafter referred to as “TAG”) of OECD, such approach can exist without fixed place of business, in case if it fulfills physical presence test<sup>39</sup>, nonetheless they have not been adopted within whole Convention, but it has been used in reports and discussed as an alternative, which might widen the application of PE concept.

As UN, has described within their commentaries, such provision is an essential tool for developing countries to claim tax revenues on circumstances, where companies cooperate with service providers located within their territories. By doing so, companies are able to reduce tax burden and in many cases, it may be a question for huge turnovers within small period of time, to which otherwise access would not be granted. For a wider protection in

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<sup>35</sup> Supra note 22, pp. 201 - 203

<sup>36</sup> Supra note 22, p. 156

<sup>37</sup> Centre for Tax Policy and Administration, “Are the Current treaty Rules for Taxing Profits Appropriate for E-Commerce? Final Report”, (2004), available on: <http://www.oecd.org/tax/treaties/35869032.pdf>, accessed on: 17.03.2020

<sup>38</sup> Supra note 22, p. 143

<sup>39</sup> Supra note 37, p. 47

2011, UN amended and added to the service's clause, 183 days in any 12-months period, which previously was of question of a fiscal year.

The existence of physical presence test within UN Convention, does not mean that by approving the test, PE would be granted. Companies still is a subject to all restrictions and rules that may cancel out the existence of PE. These rules regard the activity as being of preparatory or auxiliary nature or they are in place to divide company in smaller parts for the sake of different reasons stipulated under paragraph 4.1. of both Conventions or the service is performed by independent agent. The interpretation of UN approach of independent agent adds up the idea, that if person is closely related and partly or fully exclusively acting on behalf of the company, such person should not be regarded as independent agent<sup>40</sup>. The issue is how to interpret would be concluded as acting partly exclusively, since as from authors point of view, this sentence, seems to be supportive of physical presence test under paragraph 3.(b).

#### **1.4. Conclusions on PE concept interpretation under International Conventions.**

After reviewing the OECD and UN convention commentaries on PE concept, it is possible to draw main elements to determine what under current international conventions, must be regarded as PE and what conditions must be met to conclude that there is an existence of the PE. Also it is important to acknowledge both convention and organization importance on the global scale for combating double taxation on the same grounds equally everywhere. Both conventions are used as the basis for Double taxation treaties between countries.

Firstly, similarly as it historically developed and still unchanged is the general rule, that PE is "fixed place of business through which the business of an enterprise is wholly or partly carried on". Place of business, referring back to paragraph 1, is premises or in certain cases machinery or equipment. Place of business also can exist without actually existing premises in case if particular business activity does not have necessity for such, and it is possible to conclude that there is existence of place of business, even in situation when particular company does not own, rent or otherwise have at its possession the premises or installations, it may create existence of place of business. Place of business must contain – certain permanency and personnel, which must have a productive character.

Secondly, importance of application rules is stipulated under paragraph 4, stating that that this activity performed by fixed place of business must not be of a character described as preparatory or auxiliary. Leading to the concept of test, which evaluates activities significance through the fixed place of business, if particular activity does not play a significant role within the enterprise, it shall be regarded as preparatory or auxiliary, resulting in none-existence of PE.

Moving onto the final way of establishing the fact that there is an existence of PE is through paragraph 5, also understood as general concept of dependent agent, which mainly points out three conditions, which must be met to determine whether there particular person is or is not dependent. Firstly, person must act on behalf of the company, secondly it must be in a way that it is able to conclude contracts and can act in its own will and it directly or indirectly influences the whole business enterprise activity, thirdly the contract must be in the

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<sup>40</sup> Supra note 18, pp. 196 - 200

name of the enterprise or either It must give right to use or have transfer of ownership to the enterprise on which behalf agent is acting. Even if all conditions are met, PE can be denied if it is of preparatory or auxiliary character (paragraph 4) or actions done by the agent shall be regarded as work of an independent agent, analyzed in section 1.3.1.4.

As aforementioned, OECD Model Tax Convention and UN Model Double Tax Conventions are in a way linked together. Nonetheless there are minor exceptions, which in overall sense place lower limits to conclude an existence of PE, which mainly are to have higher protection of developing countries and for them to have a chance to claim, the attributed profits faster, as well as widening the scope of application of PE concept. UN Convention, was mentioned under paragraph 3(b), which considers that even services of the company, might constitute PE, if they are used for more than 6 months within any 12 months period, nonetheless if they fall under independent agent clause or preparatory or auxiliary activity clause, PE must be denied.

## **2. Permanent Establishment in Digital Economy**

Year by year popularity of digital enterprises worldwide increases. The ability to cover and reach markets in seconds, can be seen within worldwide market capitalization data. Since 2009, technology sector has growth ratio of about 434%<sup>41</sup> according to PricewaterhouseCoopers (hereinafter referred to as “PwC”) study, moreover tech-company share in market capitalization worldwide, has grown from 7% to 54% in the period of 2006 - 2017<sup>42</sup>, which marks the trend and proves ability to scale in short term. This means that economy worldwide is rapidly changing due to the digital business model takeover. It also significantly changes and influences whole business environment, thus meaning that new challenges under current terms in place to evaluate the e-commerce business under same conditions of how conventional businesses were evaluated, which were generally in place to solve the issues regarding conventional business model.

The fact that digital enterprise can operate from any place and not own any tangible assets, except personal computer and still make huge profits, creates a situation where it is important to reach fair deal between states where enterprise has acted and where it is located. For tax matters it means that policy in place must contribute and be in balance for both, state and digital enterprise, thus meaning that it promotes the economic development for both<sup>43</sup>. This section will analyze how current nexus rules in place on international level looks upon digital enterprises, what can be considered as permanent establishment for the states to have a right to tax non-residents acting in their states as digital enterprises and what result is reached under current rules, mainly what influence it has on states taxation rights on business profits, how does it influence digital enterprises themselves and conventional businesses and what issues can be drawn from current approach application.

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<sup>41</sup> PwC, “Global Top 100 companies by market capitalization”, (2019), available on: <https://www.pwc.com/gx/en/audit-services/publications/assets/global-top-100-companies-2019.pdf>, accessed on: 21.03.2020

<sup>42</sup> European Commission, “Fair taxation of the digital economy”, available on: [http://www.europarl.europa.eu/cmsdata/152963/Commission\\_powerpoint.pdf](http://www.europarl.europa.eu/cmsdata/152963/Commission_powerpoint.pdf), accessed: 21.03.2020

<sup>43</sup> OECD, “Tax and digitalisation”, (2018), Paris available on: <https://www.oecd.org/tax/beps/tax-and-digitalisation-policy-note.pdf>, accessed: 21.03.2020

Digital enterprises within this matter will mostly be looked upon well-known and existing e-commerce business models, excluding online advertising services. Past 10 years in business environment have been changing, mostly due to internet expansion, users and data driven algorithm development by few major players such as *Amazon*, *Alibaba*, *Facebook*, *Google*, *Oberlo*, *Shopify* and so on. Even though the ways of how business may be conducted in internet are more than we can imagine and they are evolving even more each day, as the enterprises are searching for the ways of expansion. There are few essential models which, has clarified and became popular in their effectiveness regarding online sales. Within this research and analysis of the current application on the digital enterprises, author will look at current approach of application of PE concept, with regards to these further described popular business models in e-commerce recognized by OECD.

## **2.1. E-commerce business model trends and characteristics agreed by international forum**

E-commerce business models and approaches of using internet in product or service commercialization are constantly evolving and developing. It is possible to see few popular ways through which companies develop their businesses online. For example, it is possible to take movie industry, one of the ways how to commercialize such product through internet, is subscription based business model, as *Netflix*. Second way could be by leasing the specific movie for specific time, as *Apple TV+* does. Third way could be by selling tickets to certain movies online, which can be afterwards be used physical form in theater. This example, shows that the product in general is the same, but the ways of how they might be commercialized may significantly differ. The OECD, for the sake of clarification of the current topical business models in e-commerce has recognized four main approaches.

One of the most essential and popular way to do e-business is through business model referred to as online platform e-commerce business model. In practice it is an online platform, which connects seller and buyers. It performs as a neutral toll, which has a mass of traffic and unique visitors. Resulting in a situation, where sellers have an access to wider auditorium, therefore able to scale their revenues. Online platform fulfills not only the function of connecting buyers with sellers, but also does analysis of the sellers performance, enterprise health, fastness and quality, thus if an enterprise does not reach a certain level of the performance, platform may ban it. By such analysis and activities, they are able to reach level of customer satisfaction and low retention rates<sup>44</sup>. Even though this might seem as a non-trendy way of doing e-commerce business, data shows that one of the leading economies worldwide, meaning United States of America, 41% of the whole sales on the internet goes through Amazon, which is online platform described above, also since 2015, the market share of the whole e-commerce industry has increased by 14%<sup>45</sup>, thus significance of this business model is essential within whole e-commerce industry, which also is increasing yearly.

Another way of doing e-commerce business is through subscription-based business model. This model in general is B2C based, where customer by subscribing to particular

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<sup>44</sup> OECD, "Unpacking E-Commerce: Business Models, Trends and Policies", *OECD Going Digital Policy Note*, (2019), Paris, available on: [www.oecd.org/going-digital/unlocking-the-potential-of-e-commerce.pdf](http://www.oecd.org/going-digital/unlocking-the-potential-of-e-commerce.pdf), accessed: 23.03.2020

<sup>45</sup> FTI Consulting, "2019 U.S. Online Retail Forecast", (2019), available on: <https://www.fticonsulting.com/~media/Files/us-files/insights/reports/2019-us-online-retail-forecast.pdf>, accessed: 23.03.2020

product or service, pays monthly fee in exchange for either products which are provided for a specific time period or an access to particular service, for example as a music-streaming platform like Spotify. This business model benefits to enterprise by being able to operate with lower marginal costs and long-term revenue flows with high total value spent per one customer<sup>46</sup>.

Third most popular way of e-commerce is online-offline business model, which means that additionally to offline, “brick and mortars” sales company maintains website through which it also performs online sales. This in a way is how traditional business, have expanded in internet environment, for instance, clothing companies, such as *Apranga group* or *H&M*, both maintains an online stores as well. On the same hand it is more or less understandable also from the point of view, that by doing so, they significantly are able to reduce fixed cost per purchase and increase profits on one sale of good through online platform, since as it does not require any premises, installations and so on<sup>47</sup>.

Drop shipping model could be placed under the same model mentioned above. Term drop shipping means that one person or enterprise, through online platforms or websites sells products manufactured by other enterprise. Person, who sells is only responsible for maintenance of the website and marketing, if this person sells product, other enterprise directly ships it to the buyer.

All of the previously referred business models involve many different factors and considerations regarding structure and real economic activity circumstances, also the way of doing business online with regards to all above models may slightly differ from case to case analysis. Nonetheless OECD interim report in 2018, developing tax policy rules and analyzing the current situation, has drew three main observed factors of digitalized business models, which differs from regular businesses, to help to understand in which direction tax policy must aim towards the change in tax rules. Moreover, two of the key factors are also recognized among members of Inclusive Framework, that they exist and that they are relevant for the tax purposes, nexus rules and fair profit allocation<sup>48</sup>.

First factor recognized, is Cross-jurisdictional scale without mass which mainly means that businesses with digitalization are able to process their production in various stages and in parts across different jurisdictions not only from production perspective, but also from the customer segments, allowing them to reach a huge number of customers. This can be done without any or small presence at a particular place, thus making it a scale without a mass<sup>49</sup>.

Second factor recognized is the reliance on intangible assets and intellectual property, meaning that digital enterprises in their models are highly reliant to different kind of intangible assets, which are owned or leased from third parties, for instance, data, software, and algorithms, thus their business profits are highly dependent on intangible assets that may not belong to the business itself<sup>50</sup>.

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<sup>46</sup> Supra note 40.

<sup>47</sup> Supra note 42

<sup>48</sup> OECD, “Tax and digitalisation”, *OECD Going Digital Policy Note*, (2018), Paris, available on: <https://www.oecd.org/tax/beps/tax-and-digitalisation-policy-note.pdf>, accessed: 25.03.2020

<sup>49</sup> Ibid. p. 4

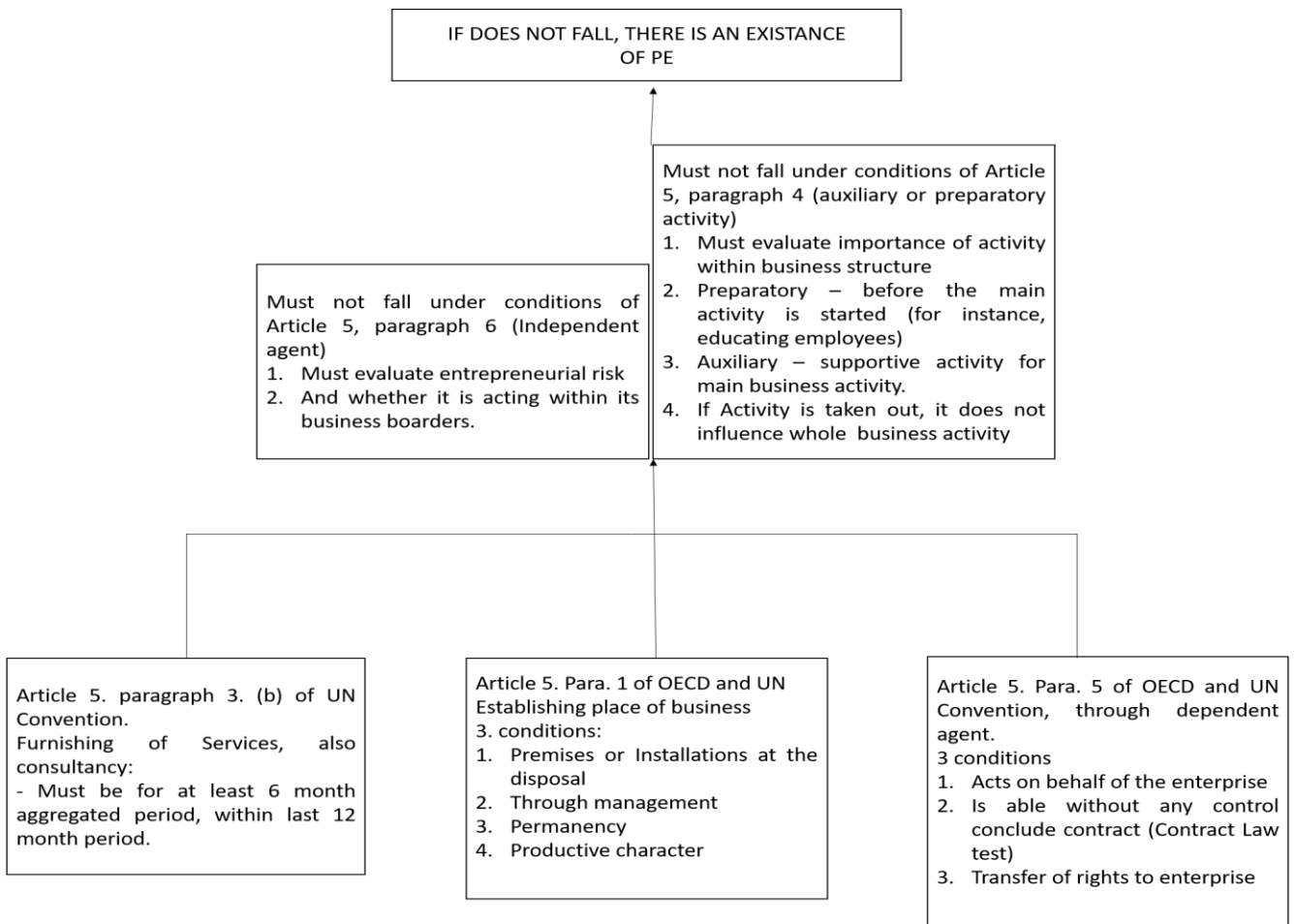
<sup>50</sup> Supra note 44, p. 4

Third factor is data, user participation and their synergies with IP and intangible assets. This is referred to two things, first - digital enterprises are highly dependent on data and amount of it contributed; second - data usage for effective management in the enterprise in processes as marketing, planning of manufacturing and finance. This factor has not been agreed by the members of Inclusive Framework, therefore currently there is no clear approach of how to evaluate data as a part of the value creation for the enterprise, meaning, and certain amount of data would not show its impact towards business profits. Currently it is not clear how to properly evaluate which data unit has created certain value for the company because as already mentioned it is not clear how to distinguish quality of the data unit, moreover, data as a measure, can only be reliable and value creating when the data collected creates certain correlation. Analysis of the data is mainly done by using algorithms which makes it impossible to collect information of how much the given data has contributed to the revenues of the company. Each data unit benefits to the company somehow but the given benefit is hard to evaluate therefore there is zero or relatively little support for third factor to be recognized as important for nexus rules.

## **2.2. Permanent Establishment application to digital economy in practice**

As far as the Model Tax Conventions has developed there have been changes within their framework regarding nexus rules through commentaries, reports and amendments for the application to digital enterprises PE concept because of the popularity gained. From the perspective of IBFD reports and BEPS action plans it can be seen that the International Forum has recognized the need for adopting new rules to properly tackle issues arising from international taxation. Digital enterprises is an existing notion nowadays to which current rules apply therefore according to research done previously on current international rules of PE the author constructed a table which might be used as a test to determine the existence of PE regarding e-commerce companies by excluding unrelated rules.

Table 1. – A. Zingulis, Test to conclude existence of PE under UN and OECD approach



### 2.2.1. PE through receiving services

An interesting and unclear approach of concluding an existence of PE, which also creates different treatment under OECD and UN approach is existence of PE by receiving services<sup>51</sup>. This test mainly asks for 2 components to be regarded as PE, firstly 6 months period of receiving such services within any 12 month period and that the services is not auxiliary or preparatory activity or services are not received as from independent agent. Under this approach there is no necessity of existence of fixed place of business<sup>52</sup>. Thus it would mean that, for instance company A, which is online retailer selling physical goods, located in state A, receives services from company B, who maintains platform on which companies A website is built in state B within last 6 months of 12 month period, would be regarded as PE in state

<sup>51</sup> M. Lenard, "The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Point of Difference and Recent Development", *ASIA-PACIFIC TAX BULLETIN*, (2019), available on: [https://www.taxjustice.net/cms/upload/pdf/Lennard\\_0902\\_UN\\_Vs\\_OECD.pdf](https://www.taxjustice.net/cms/upload/pdf/Lennard_0902_UN_Vs_OECD.pdf), accessed: 28.03.2020

<sup>52</sup> Committee of Experts on International Cooperation in Tax Matters, "Proposed Guidance on Permanent Establishment in the Extractive Industries", (2016), New York, available on: [https://www.un.org/esa/ffd/wp-content/uploads/2016/12/13STM\\_CRP22\\_Extractives\\_PEs.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2016/12/13STM_CRP22_Extractives_PEs.pdf), accessed on: 28.03.2020

B. Platform is their main income source, therefore it is not auxiliary or preparatory action. But, PE would only exist if Double Taxation Treaty between state A and B would consider that there is a possibility to establish service PE.

Application in practice for digital enterprises is not clear, since as initially the idea of this clause was to grant taxing rights for developing countries, which from such perspective would be efficient within regards to their ability to retain incomes generated in their territory, nonetheless there is a possibility that companies may artificially use this clause to be bound by rules of such countries, for the aim to benefit from the taxation rules in place. This is a speculation of how such clause could be used, since as there is no practice towards usage of such approach for digital enterprises<sup>53</sup>.

### **2.2.2. Servers and Websites as Permanent Establishment**

The bases of PE, also from the historical point of perspective is PE through fixed place of business, which as it has been analyzed entails four factors to conclude that either there is or is not an existence of fixed place of business. The main idea of application of this principle, has not significantly changed in codified rule meaning, nonetheless commentaries of OECD Model Tax Convention of Article 5(1), has concluded few topical issues of what must be regarded as fixed place of business in online environment. The main issue question, which was solved through commentaries, was regarding websites and servers as fixed place of business. OECD commentaries stated following:

“Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated, a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a “place of business” as there is no “facility such as premises or, in certain instances, machinery or equipment” as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a “fixed place of business” of the enterprise that operates that server.”<sup>54</sup>

With this commentary OECD clarified that website itself cannot constitute PE, the way of how website would be regarded as PE is only in connection with existence of servers which are leased by the company or either owned and maintained<sup>55</sup>. Nonetheless, even in case of leasing, PE may be declined based on independent agent clause. Moreover if the server is owned by the e-commerce company, PE could be declined if the operation of this activity

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<sup>53</sup> N. Rastogi, S. C. Ruchelman, “The Changing Face of Service Permanent Establishment”, (2017), available on: <http://publications.ruchelaw.com/news/2017-10/India-service-PE.pdf>, accessed on: 28.03.2020

<sup>54</sup> P. Hongler, P. Pistone, “Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy”, *IBFD*, (2015), available on: [https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Redefining\\_the\\_PE\\_concept-whitepaper.pdf](https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Redefining_the_PE_concept-whitepaper.pdf), accessed on: 29.03.2020

<sup>55</sup> S. Wagh, “Digital Permanent Establishment (Digital PE): A Road Ahead for E-commerce Taxation”, (2013), available on: [https://www.academia.edu/3797885/Digital\\_Permanent\\_Establishment\\_Digital\\_PE\\_A\\_Road\\_Ahead\\_for\\_E-Commerce\\_Taxation](https://www.academia.edu/3797885/Digital_Permanent_Establishment_Digital_PE_A_Road_Ahead_for_E-Commerce_Taxation), accessed: 29.03.2020



would be of an auxiliary or preparatory kind. For instance, if the server is placed but it does not host a website on it, the existence of PE could also not be claimed<sup>56</sup>.

The same idea that was developed historically through first League of Nations work<sup>57</sup> regarding PE and fixed place of business still has remained. There has been less of development and adoption towards new business models and digital commerce. It still asks for physical location through which productive activity is done. This however, leads to fundamental questions of whether even this existence of fixed, physical place is relevant towards digital enterprises, also it can be observed that the current rules creates situation where servers are regarded as PE, thus leading to situation where server offshores are in place or companies by themselves establish servers in the specific territories and jurisdictions, to use them for tax burden reducing purposes<sup>58</sup>.

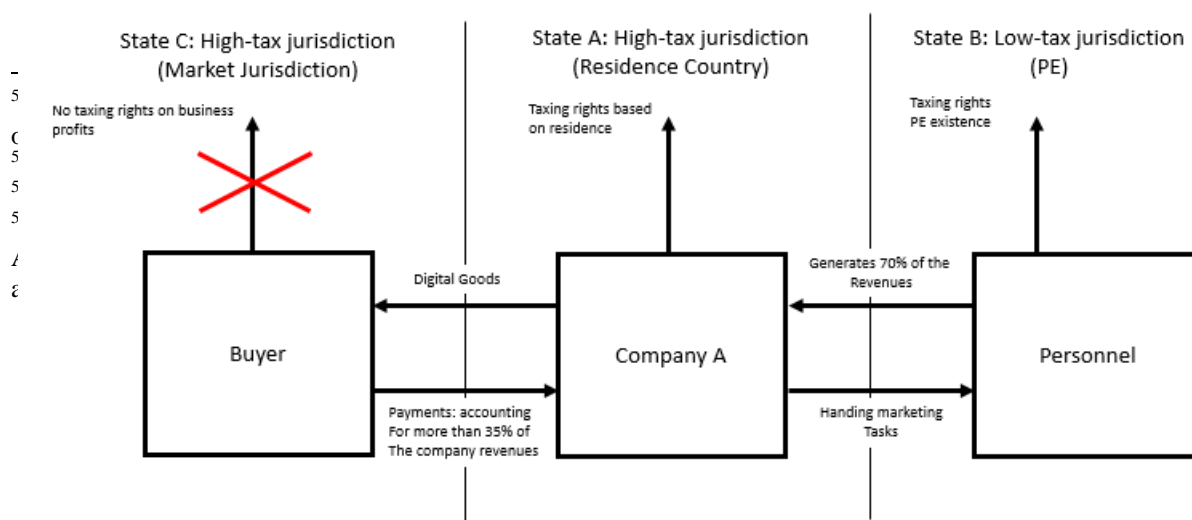
### 2.3. Legal and Economic issues arising from current application

As it was mentioned, within sections covering application of current PE principles to digital enterprises, the main issues divide mainly in two parts, first of all the ways of how companies could be able to use these application rules in favor, to create circumstances, which benefit to their taxation rules for business profits. Secondly, how current application rules could possibly be harmful for overall situation for income of business profit taxation within state budget.

Currently International Conventions points out three main roads to conclude that there is an existence of PE for digital enterprises, however still it depends on DTA between both countries. Within further analysis it will be assumed that countries within their agreements, have recognized all three possible ways as it is, for instance in DTA between the Republic of Latvia and the Government of Malta<sup>59</sup>.

Furthermore, in hypothetical situation - Company A, which is Online retailer selling digital goods worldwide and it is resident in State A. 70 percent of its income comes from Facebook marketing, which is managed in State B and more than half of these revenues are from State C. Due to the taxation rules in place in State B, digital enterprise could be interested to be taxed in State B for their business profits due to the fact that CIT rate in State B is 12.5 percent in comparison with State A where the CIT rate is 25 percent (see table 2.). For this company to be taxed on business profits in State B, it would be an assessment based on regular PE rules of DTA between both countries, in this situation it is assumption that State A and State B, has the same DTA as between Latvia and Malta, this DTA is combination of UN Convention and OECD Convention, thus it would earn that previously

Table 2. – A. Zingulis, Figurative explanation of hypothetical situation



developed test would also be relevant and applicable.

If this test applies, Company A could establish PE in three main ways. Firstly, if marketing management is done through services received via employees or other personnel at the disposal of Company A in State B. Secondly, by placing servers in State B on which the website is hosted. Thirdly, through dependent agent clause, where for instance person working as freelancer<sup>60</sup> manages the budget and is at direct disposal of enterprise, thus assumption in this case would be that this person is regarded as dependent, not falling under independent agent clause. Even though these kind of situations could be legitimate, they could also be artificially created for the benefit gained from the tax system in State B. For instance, specifically searching for partners in one country or otherwise acting to fall under current PE rules, thus paying less taxes in State A, where the burden is higher.

Following the situation from direct taxation point of view, would thus result in situation where Company A, would be taxed in State A and as far as attributed profits would go, then in State B, whereas two main conclusions could be drawn. First of all, under the current rules Company A, could work or act in certain way to be considered as PE in State B, thus State B would have taxing rights to the profits attributed to the that particular PE and State C, would not have any rights to tax on profits. Second issues arise from the principles on which whole double taxation system is built, since League of Nations, where the Economists in 1923, stipulated that international taxation shall be based on economic allegiance doctrine saying, “*whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income*”<sup>61</sup>. This doctrine pointed out seven main important factors on which international taxation is built, from which Economists concluded that most important, although depending on class of income, were two factors. Firstly, the origin of the wealth, thus source from which income derives and secondly where the wealth has been spent, mainly referred to residence territory<sup>62</sup>.

This previously analyzed case, did not give any direct taxation rights to the State C, from which 35 percent of whole Companies A income derived from. Also by current PE rule application for digital enterprise, residence country in this case State A, could suffer from the perspective of reduced income on business profit taxation, since as also PE could be established in State B, to be bound by less burdened taxation systems. Thus, the issue question within this regards is that, current rules of PE for digital enterprises do not comply with fundamental principles on which double taxation rules were built up on and are not fair and efficient, which is also one of the main fundamental principles of international double taxation, towards jurisdictions from which income originates<sup>63</sup>. Moreover, current system has

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<sup>60</sup> “Freelancers are defined as self-employed professionals often working in creative, managerial or technical fields, i.e. they are so-called knowledge workers. They can operate under various legal business forms, such as, sole traders, partners in unincorporated businesses or directors of their own limited companies.” – J. Pekhonen, “Freelancer as an owner-manager – the challenges and opportunities of knowledge-based self-employment”, (2013), available on: <https://core.ac.uk/download/pdf/38095701.pdf>, accessed: 04.04.2020

<sup>61</sup> Supra note 56, p. 11

<sup>62</sup> Supra note 59

<sup>63</sup> OECD, “Fundamental principles of taxation”, in *Addressing the Tax Challenges of the Digital Economy*, (2014), Paris, available on: <https://www.oecd-ilibrary.org/docserver/9789264218789-5-en.pdf?expires=1586200843&id=id&accname=guest&checksum=9DCD961ED353FCF69AEE1C2AF6AB9DC> C, accessed: 06.04.2020

created situation, where companies by intentional actions may shift essential processes of the whole business activity through digital means and establish PE elsewhere.

This leads to the fact that digital enterprises, has changed the way of how business operates, residence place, has become less of importance, same as physical existence. From the historical point of view, more specifically equivalence theory, developed by Thomas Sewell Adams, who was prized by American economists on his early stage works for League of Nations on taxation policy, it is understandable, why residence and PE principle is still of the importance for international taxation, citing:

“A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment . . . . Business is responsible for much of the work which occupies the courts, the police, the fire department, the army and the navy. New business creates new tasks, entails further public expense . . . . The relationship between private business and the cost of government is a loose one . . . . The connection, however, is real . . . . Business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.”<sup>64</sup>

Business by employing their employees, renting premises and so on are creating cost for the government, which thus creates opportunities and environment for these people to operate, not only from the business perspective, but also from the perspective of the daily life of human being, which has an access to the infrastructure and social guarantees maintained by the government. This also does not change if business entity is regular “brick and mortar” store or it is “click and mortar” entity. It still withholds in itself some costs which are incurred by the government. Nonetheless, the cost is smaller in case of the digital enterprise within regards towards government’s budget than it is for regular business, since as the amount of premises and people are not necessary in such amounts. Example for this is Facebook corporation, which had 35 587 employees<sup>65</sup> in 2018 with turnover of 55 838 million revenues in U.S. Dollars<sup>66</sup>, in comparison with Siemens AG, which had at the same time 379 000 employees<sup>67</sup> and revenues of 83 044 millions in U.S. dollars<sup>68</sup>, which shows that amount of employees for Siemens AG is more than 10 times of what Facebook has, whereas the revenues are only by 33 percent bigger than Facebooks, also notably Facebook’s Plant, Property and Equipment (hereinafter referred to as “PPE”) in 2019 accounts for 3.5 billion U.S. dollars, while Siemens AG had 12 billion U.S. dollars. All facts together, leads and mean that all the costs for governments involved are significantly higher only due to the fact that more people are involved, also taking into account premises and other expenses to the infrastructure. This shows, that it is not only about source, from which income is arising, but

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<sup>64</sup> B. Hoffart, “Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach”, *VOL.6, NO.1, Northwestern Journal Of Technology And Intellectual Property*, (2007), available on: <https://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1060&context=njtip>, accessed: 10.04.2020

<sup>65</sup> J. Clement, “Number of Facebook employees 2004-2019”, (2020), available on: <https://www.statista.com/statistics/273563/number-of-facebook-employees/>, accessed: 10.04.2020

<sup>66</sup> J. Clement, “Facebook: annual revenues 2009-2019”, (2020), available on: <https://www.statista.com/statistics/268604/annual-revenue-of-facebook/>, accessed on: 10.04.2020

<sup>67</sup> Macrotrend, “Siemens AG: Number of Employees 2006-2019”, (2019), available on: <https://www.macrotrends.net/stocks/charts/SIEGY/siemens-ag/number-of-employees>, accessed: 10.04.2020

<sup>68</sup> I. Wagner, “Siemens AG – revenue 2010-2019”, (2019), available on: <https://www.statista.com/statistics/266153/revenue-of-siemens-ag/>, accessed: 10.04.2020

also about rationalization of residence principle based on enterprises establishment's cost to jurisdiction or state. However, as it can be seen PPE does not explicitly determine and correlate with origin of wealth, thus reducing significance of tangibles within business processes and revenues, but still it is as the main factor which currently determines taxing rights on business profits within PE principle.

To summarize it up, international double taxation is built upon two main principles previously discussed, origin of wealth and residence principle, nonetheless both principles in some way currently are leaning towards the supply side of the business and in certain extent it is understandable, due to the previously covered equivalence theory developed by Thomas Sewell Adams (1873-1993), who was economist and professor at Yale University until his death<sup>69</sup>. On this theory grounds double taxation has been built historically and it logically rationalizes the PE principle within its fundamental elements and core aim. But, the issue is that current approach from the direct taxation point of view completely ignores the fact that demand itself also is essential part of creating the value. Professor Eric Kemmeren (1963-present), from Tilburg School of Economics and Management<sup>70</sup>, referred to this similarly, saying that things, premises and more broadly tangibles itself does not create value, it is complex process of supply and demand, because without demand in the market there would be no value created<sup>71</sup>.

In current situation, demand side only comes into play, after PE is established, when attributed revenues for PE must be examined. This is working concept for entities who need physical place to operate, however not for digital businesses and such situation therefore leads to the case as it was previously covered in hypothetical situation, where the state which accounted for 35 percent of the whole revenues of the company did not have any taxing rights. Thus, it must be an evaluation of supply and demand within origin of wealth and on allocation of taxation rights, which currently are not covered in the rules of PE specifically for digital enterprises. Therefore, the current situation in market, from the perspective of PE application to digital enterprises, asks for changes, either by reconstructing whole PE concept or adding up on it new nexus rules, firstly to exclude possibility for digital enterprises to act in a way to benefit from the current PE rules and secondly to reach fair result in double taxation rules and grant rights in a way that complies with origin of wealth including also demand factor and markets influence on revenues generated by the company.

### **2.3.1. Uncertainty in Country-by-Country Application**

To continue, PE system is not only leaving gaps for digital enterprises, it also in broad terms does not cover wholly issues within regular business activities. Author after conducting interview with, Giammarco Cottani, who is Global Tax Policy Director at Netflix, which had 20 billion USD turnover in 2019 and 65 million subscribers with more than 100 million users

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<sup>69</sup> Wisconsin Historical Society, "Adams, Thomas Sewall (1873 – 1933)", *Dictionary of Wisconsin biography*, available on: <https://www.wisconsinhistory.org/Records/Article/CS4700>, accessed: 10.04.2020

<sup>70</sup> International Tax Law faculty – Vienna, "Eric Kemmeren", (2020), available on: [https://www.international-tax-law.at/prospective-students/faculty/?tx\\_itlprogram\\_speaker%5Bspeaker%5D=32&tx\\_itlprogram\\_speaker%5Baction%5D=show&tx\\_itlprogram\\_speaker%5Bcontroller%5D=Speaker&cHash=4218ba0f622b24443964bce2cf31fcf5](https://www.international-tax-law.at/prospective-students/faculty/?tx_itlprogram_speaker%5Bspeaker%5D=32&tx_itlprogram_speaker%5Baction%5D=show&tx_itlprogram_speaker%5Bcontroller%5D=Speaker&cHash=4218ba0f622b24443964bce2cf31fcf5), accessed: 01.05.2020

<sup>71</sup> Supra note 54, p. 18

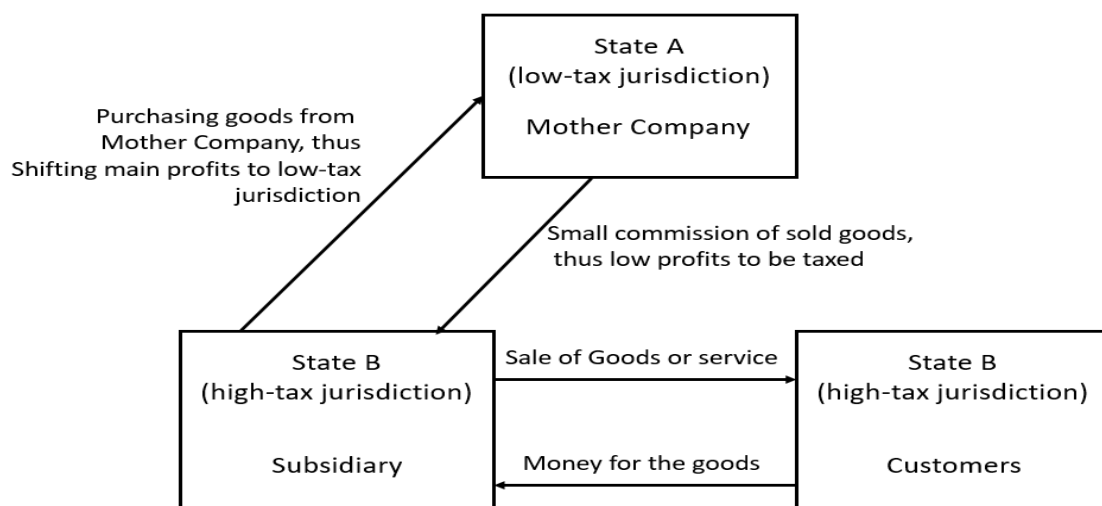
in the same financial year, acknowledged that currently there is too high level of discretion left to the countries. Saying that it, thus creates gray area of falling under the PE in one country and not falling under PE in other country, by the same rules in place. Following the interview, Mr. Cottani, said that businesses thus are left on the grounds, where it is uncertain, how to act in global space, since as application is not unified, even though rules might seem the same. Argumentation of this can also be proven in the Dell Case in Spain and in Norway, where two equal situations took place, but the rulings by the court answered it in two completely different ways.

In the case of Spain vs. Dell, June 2016, Supreme Court, Case No. 1475/2016, factual circumstances were that Dell Ireland, had commissionaire agreement with Dell Spain, which was full-fledged distributor covering customer support and other business operations, while Dell Ireland mainly works as manufacturer. The commissioner agreement means that Dell Spain would receive percentage of sales done in Spain. The discussion of the court was mainly about dependent agent clause and fixed place of business at the disposal of Dell Ireland. The Spanish Supreme Court ruled that Dell Spain must be regarded as PE of Dell Ireland, due to the fact that Dell Spain exclusively represent Dell Ireland, and there is no need of direct representation through agreement, since as factual and functional analysis of the Dell Spain<sup>72</sup>, leads to conclusion that such agreement can be established by defacto<sup>73</sup>.

On the other hand, in the case of Dell in Norwegian Supreme court on December 2<sup>nd</sup>, 2011, court on the same factual circumstances ruled that to establish PE on the grounds of dependent agent, it has to comply with two conditions, first that it must on behalf of the Dell Ireland and second, that Dell Norway, has authority to conclude contracts on behalf of the Dell Ireland<sup>74</sup>. Afterwards, the court referred to the Zimmer Case in France, which said that – *“commissionaire acts in its own name and cannot bind its principal, [...]even if commissionaire is clearly not independent”*<sup>75</sup>. Thus, second condition is not met and PE cannot be established based on dependent agent clause<sup>76</sup>.

From these two cases with equal circumstances, but with different outcomes, can be drawn two following conclusions and concerns. First issue, is that already current system for regular business does not tackle all avoidance practices, not only from the perspective of intentionally acting to be bound by certain rules, but also from the standpoint of avoiding the PE in high-tax jurisdictions. Commissionaire agreement, thus is a way to avoid the direct tax liabilities in high tax jurisdictions (see table 3.), to which business including digital enterprises places focus due to higher purchasing power. Second issue, is approval of the fact that tax authorities and courts, are able to go beyond lines of the PE principle already. For

Table 3. – A. Zingulis, Commissionaire agreement for PE avoidance



business it results in volatile, uncertain environment, which might reduce their intent to act and grow worldwide, since as rules in place does not grant any certainty even without any additional nexus rules for digital enterprises, this was also main concern which was mentioned by G. Cottani, who represents Large Multinational Company.

### **3. Current Ideas for Creation of Effective Nexus Rules in Future**

Issues stipulated above are not completely unknown to the international organizations as OECD and also they are recognized by national governments worldwide. From the year 2004 perspective Technical Advisory Group (hereinafter referred to as “TAG”), pointed out that they could not be the ones who discuss the possible issues, it is up to states how they approach the possible effect of the e-commerce stores on the tax revenues of each jurisdiction. TAG continued with the fact, that at the time it would be speculation of the impact on the direct taxation arising from the digital enterprises since as there is little data on the losses incurred from the governments, thus the significance of the taxation issues in the light of the argumentation of TAG lacks evidence. As it arises from the statements within reports, to avoid double taxation and non-taxation of business profits internationally, it asks for consensus of possibly more states, to reach effective system to combat issues possibly arising. Thus, examining approaches, how to combat the possible issues arising from e-commerce, TAG mentioned two possible scenarios, how OECD could act to reach fair and effective rules for digital commerce<sup>77</sup>.

TAG said that current PE principle is already widely accepted principle, recognized by the international forum in various conventions, mainly placing focus on two essential conventions by the OECD and UN. Following its argument TAG pointed out two main questions, for alternative nexus rules, first question is how likely new nexus rules could reach the same level of acceptance and second question is what transition issues would arise from replacement of the current rules. According to TAG, based on these two question and the issues topicality in general, international forum must agree and go with one of the possible solutions below.

On the one hand, TAG continued that international community may completely and fundamentally revise the current rules and adopt the rules for digital commerce separately with PE rules. Which would thus mean that the question of acceptance of the international forum is questionable, since as radical changes would ask most probably lead to situation where some states significantly benefit due to the fact that there are huge profit shifts out of the country, and others will significantly loose. Also transition issues arising from radically new nexus rules would, mean that countries would have to renegotiate bilateral tax treaties, on average tax treaties remain unchanged for 15 years. Thus it would take a long time and if 15 years are compared to the growth dynamics of digital enterprises, it would most probably be even harmful for the direct tax revenues to the jurisdictions in question. Also taking into account and understanding that for instance Irelands DTA system is built to benefit from the tax revenues of MNE, their interest to cooperate would be limited with regards to taxation of business profits, since as it is one of their strategies as a country. Nonetheless, it does not explicitly mean that it would not be possible, it would just take long time, but there must be

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<sup>77</sup> Supra note 56, p. 15

an evaluation of other alternatives to reach the result in proportional and most efficient manner<sup>78</sup>.

On the other hand, understanding the fact that current rules has high level of acceptance and it is not 100 percent clear how significant direct taxation losses for the governments could be in the nearest future, also noting the previously mentioned fact that the current situation lacks evidence on the significance of the losses, TAG, advises to continue on the same grounds as the PE has been built, but with additional rules or nuances, within current article 5 or commentaries to cover the issues arising from the growth of the digital enterprises by monitoring the influence on the economy and on the profit and business process shifting to favorable jurisdictions.

In 2004 TAG group concluded, that it would not be wise to implement new nexus rules and that the rules in place sufficiently are taking care of the digital enterprise tax related issues, Giammarco Cottani on this also partly agreed with the fact that it is not advisable to take radical moves to recreate the PE system, he argued that such scenario could possibly lead to the system where new uncertain nexus rules are built on already uncertain PE concept, covered previously. Such situation, thus could lead to even higher certainty, which would affect business development, thus growth also from economic perspective of the countries. However, on the opposite, he does not agree that current PE concept sufficiently takes care of digital enterprises, since as it even does not take sufficiently care with problems of regular business, not taking into account digital enterprises. Moreover he stipulated that, it is a fact that there is a need to create additional rules for current environment where physical presence is off the topic regarding conduction of business activity, but the question is how to tackle it in a way not to make it even more complex and uncertain, which important thought of consideration when developing new nexus rules and whole system of taxing right allocation between states. Furthermore almost within all considerations and conclusions of TAG, they mentioned that the situation in the market must be monitored<sup>79</sup>.

Nine years later OECD/G20 developed BEPS action plan in 15 points for addressing the tax challenges of the digital economy. In so far, they are working on new and updated Inclusive framework for BEPS project under pillar one and two<sup>80</sup>, whereas taking look back to 2004 conclusion by TAG, it would be first mentioned case - radically new solution and rules, which at that time was not recommended by TAG. Although it must be also mentioned that seemingly changes are happening and currently will most probably be implemented in three main blocks internationally. Firstly, through changes in Inclusive Framework under Pillar One amending and supplementing allocation of taxing rights through new nexus rules, Inclusive Framework's includes 137 countries, which must uniformly agree on proposals and rules, in case if it is uniformly agreed, it becomes as binding instrument for all countries to implement new provisions within their domestic laws. Secondly, through The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (hereinafter referred to as "MLI ") with 94 signatory countries and lastly through

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<sup>78</sup> Supra note 56, pp. 29-30

<sup>79</sup> Supra note 56. pp 72-73

<sup>80</sup> OECD, "Addressing the Tax Challenges of the Digital economy, Action 1 – 2015 Final Report", (2015), available on: [https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report\\_9789264241046-en](https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en), accessed: 13.04.2020

OECD Model Tax Convention's article 5 and 7, to mainly build it address these challenges also within line of the OECD Model Tax rules<sup>81</sup>.

### **3.1. New Nexus rules through Unified approach of Inclusive Framework under Pillar One**

Policy note Addressing the Tax Challenges of Digitalization of the Economy, approved on 2019, has set out that the Inclusive Framework, which is divided into two pillars, must reach consensus based solution without prejudice among members of the Inclusive Framework.<sup>82</sup> Under the Pillar One, the general idea is to re-stabilize the international taxation rules with respect to the new business models appearing in the market and also to reach unified approach of granting wider taxing rights to the market jurisdiction. This pillar has distinguished three types of profits that may be allocated to the market jurisdictions, called Amount A, B and C<sup>83</sup>.

Amount A referees to a share of residual profits that could be attributed to the market jurisdiction irrespective of whether it has physical presence at the particular jurisdiction, which respectively is the development of the new taxing right rules. Amount B referees to the fixed rate of remuneration for the baseline marketing and distribution functions<sup>84</sup> and Amount C widens application Amount B, saying that it also includes any extra profit where in-country functions exceed the baseline<sup>85</sup>. Further analysis will only cover policy question of new nexus rules and industries public opinions with regards to the possible problematic practical issues and concerns, which might appear with implementation of the new rules.

Consequently the approach on which new nexus rules should be built are user participation, marketing intangibles and significant economic presence. Even though in essence all of the three key factors are different with regards to their objective and scope, they all widens taxation rights exactly for the country where the customer is based, thus market jurisdiction<sup>86</sup>, also taking look back to previous section, market jurisdiction was exactly the one which suffered from the perspective of taxation rights on business profits based on current rules for business taxation internationally, thus involving nexus rules. Currently the whole procedure is in the listening stage, where companies, NGO's, governments and also scholars can express their position regarding the current topical issues in place for them and also the approach of how they see development and emergence of the new rules. Nonetheless, so far the development of the new nexus rules, has reached some conclusions of how the policy should look and what it must include.

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<sup>81</sup> OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy", *OECD/G20 Inclusive Framework on BEPS*, (2019), Paris, available on: <https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf> accessed: 14.04.2020

<sup>82</sup> Supra note 79. p. 20

<sup>83</sup> OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020", *OECD/G20 Inclusive Framework on BEPS*, (2020), Paris. Available on: [www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf](http://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf). Accessed: 16.04.2020

<sup>84</sup> Ibid. p. 8

<sup>85</sup> J. White, "OECD presents 'unified approach' to profit allocation", (2019), available on: <https://www.internationaltaxreview.com/article/b1hhyplmx1dh75/oecd-presents-unified-approach-to-profit-allocation>, accessed: 16.04.2020

<sup>86</sup> Supra note 81, p. 11

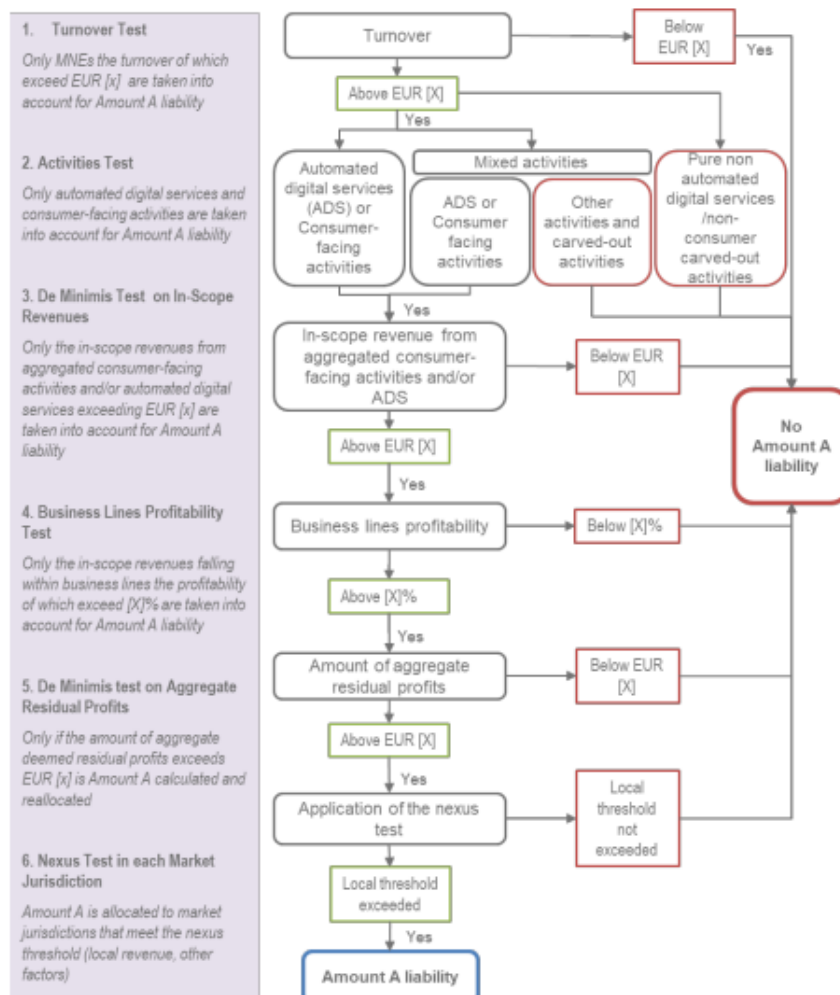


### 3.1.1. Work done so far corresponding to the new nexus rules on the OECD, EU and Domestic levels.

New nexus rules under amount A, currently are developed in with respect to consumer facing activities, thus placing focus on digital B2C business models. Last statement of OECD/G20, pointed out that the new nexus rules will be applied to specifically automated digital services, including online search engines, social media platforms, online intermediaries, digital content streaming, online gaming, cloud computing and online digital services, which would be non-exhaustive list and would only cover these. Nonetheless the scope of application will also include other consumer-facing business, such as selling goods or services to individuals for personal use, within these statement they used an examples of personal computing products, clothes, cosmetics and so on<sup>87</sup>.

Moreover, the new nexus rule conceptional form, will be built upon threshold principle, mostly to reach fair and rational balance between administrative burden and intended tax revenues. Also to be able to conclude whether eligible market jurisdiction in economic reality plays significant importance for the enterprise revenues, with respect to permanency and long-lasting connection to the state. Due to the this fact, OECD/G20 has decided that these rules will only be applicable to the Mega Multinational Enterprises (hereinafter referred to as “MNE”). The threshold could be the same as it is intended to be as for country by country reporting, which thus is revenues exceeding 750 million Euros. This would mean that small and medium enterprises will not fall under new nexus rules, to avoid unnecessary

Table 4. – OECD, Application of Amount A to grant taxing rights for the market jurisdiction.<sup>87</sup>



<sup>87</sup> Supra note

compliance costs for them and also for less overburdened work for tax administrations<sup>88</sup>. Nonetheless, the turnover threshold will only be the one of the six tests (see table 4.), that MNE would have to comply to give a rise of a taxing rights to the market jurisdiction. Other thresholds, will also sort out MNE which hypothetically would not give such benefit to the market jurisdiction, from the perspective of monetary value and also to clarify and balance out, whether the market jurisdiction really, has had such an importance within value creation process, where specifically nexus rules will guide.

So far it has been decided that the new nexus rules to determine significant presence and sustainable engagement with the market, will be based on several indicators, currently not precisely discussed. So far it is decided, that in-scope revenues over the years will be the primary factor to determine whether MNE has significant interaction with the market, also noting that de minimis rules, determining minimum threshold and markets size should be taken into account. Nonetheless, the trend and possible outcomes could be taken from the domestic laws, which has already enacted somekind of approaches to digital enterprises regarding taxation of business profits and also proposals by EU commission on Digital Significance Directive and Digital Tax Directive could be the outcomes to which accordingly OECD may derive its solution on the understanding of significant presence and sustainable engagement. Two countries with already existing rules within their domestic law systems are Israel and India.

### **3.1.1.1. Israel and India's domestic law approaches towards digital presence**

Israel has created a list of activities that shall be deemed to be considered as digital presence within Israel, thus saying that, in case if enterprise complies with one of the activities, it should also be liable for CIT charges under Israel's domestic laws. The list consists of four activities, nonetheless it also says that digital presence is not limited to them. First, activity is that significant number of contracts are signed by enterprise and Israeli customers, second is significant use of services or goods by Israeli customers, third is localised website, meaning that enterprise maintains website specifically for Israeli customers, for instance it may include language, local discounts, marketing activities, currency and so on, lastly multi-sided business model, saying that company generates significant amount of revenues exactly from Israeli customers<sup>90</sup>. Nonetheless, this approach leaves many open questions regarding interpretation of wording, included into activities, such as "significant number of contracts", "significant use of services or goods", "significant amounts of revenues". It is clear that to some extent it might be an analysis on case by case basis, but in general, it only creates even more issue questions.

India's approach slightly differs from the Israel's, India distinguished two main characters through which non-resident may be considered as liable to corporate income tax laws of India, due to having significant economic presence. First way to conclude that non-resident has significant economic presence is that threshold based on local revenues is reached with respect to any sale transactions, second approach is if the non-resident has reached

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<sup>88</sup> Supra note 83, p. 12

<sup>89</sup> Supra note 83

<sup>90</sup> OECD, "Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS", *OECD/G20 Base Erosion and Profit Shifting Project*, (2018), Paris. Available on: <http://dx.doi.org/10.1787/9789264293083-en> accessed: 26.04.2020

threshold based on number of local users, which must be systematic and contingent business activity and interaction with number of users in India. Application of rules does not depend on any physical presence through PPE or personnel, nonetheless it only serves as a gap filler, any international taxation rules prevail, thus also definition of PE<sup>91</sup>.

### 3.1.1.2. EU approach towards digital economy

European Union in its report on A Fair and Efficient Tax System in the European Union for the Digital Single Market, pointed out that one of two key questions of regulating digital market is the nexus<sup>92</sup>, respectively where to tax. With regards to new nexus rules, EU Commission has released two directive proposals, Common Consolidated Corporate Tax Base Directive (hereinafter referred to as "CCCTB") and Digital Significant Presence Directive. Both directives in a way work as supplementing instruments to regulate digital enterprises, which has substantial presence in particular jurisdiction, *'aiming at better aligning rights to tax with actual economic activity'*<sup>93</sup>.

CCCTB directive, which was proposed in 2011, even before OECD/G20 BEPS program and reports on addressing Tax Challenges Arising from Digitalization, in its core, idea was proposed to facilitate and reduce administrative burden for tax administrations, meaning that companies would only have to submit documentation at one tax authority which would be Europe, thus tax authorities would have less transfer pricing issues and number of cases where there would be a need for country-by-country reporting, resulting in less work load<sup>94</sup>. CCCTB using formula, would weight out the share of each related persons contribution to whole business structure and activity, thus allocating only certain proportion of incomes or profits to the particular entity. Within such approach, CCCTB aims to take into account one third of the sales, one third of payroll to employees and number of employees and one third of assets owned by the particular entity (see figure 1.). Such approach of allocation of taxing rights, includes and to certain extent balances out supply side and demand side of value creation. Nonetheless, the scope of application of CCCTB only currently would be applied to Large Multinational Enterprises, which first of all belong to the group of companies, secondly, which revenues during relevant financial year exceeds EUR 750 000 000 and it must have PE in particular location<sup>95</sup>. Thus to be sufficiently also applied to digital enterprises, EU Commission proposed Significant Digital Presence Directive, which recognized the issue of CCCTB lacking scope of application, moreover only covering large multinational enterprises<sup>96</sup>. Significant Digital Presence Directive, points out three main

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<sup>91</sup> Supra note 90, p. 138

<sup>92</sup> European Commission, A Fair and Efficient Tax System in the European Union for the Digital Single Market, (2017), Brussels, available on: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/1\\_en\\_act\\_part1\\_v10\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/1_en_act_part1_v10_en.pdf), accessed: 26.04.2020

<sup>93</sup> OECD, "Addressing Base Erosion and Profit Shifting", (2013), Paris, pp. 15, 20 and 51, available on: <https://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm>, accessed: 26.04.2020

<sup>94</sup> European Commission, Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB), (2016), Strasbourg, available on: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/com\\_2016\\_683\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_683_en.pdf), accessed: 26.04.2020

<sup>95</sup> Supra note 89, p. 8

<sup>96</sup> European Commission, Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence, (2018), Brussels, available on:

factors, whereas if enterprise meet one of conditions in particular jurisdiction, it would thus create taxing rights for that jurisdiction. First factor is revenues exceeding EUR 7 000 000, second factor is number of users exceeding 100 000, third factor is B2B contracts exceeding 3 000.

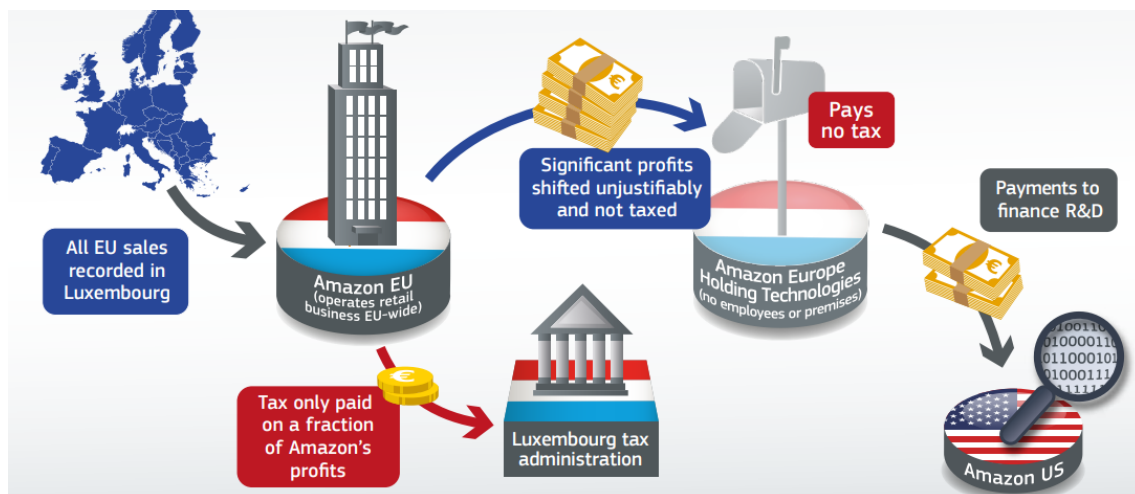
Figure 1.- EU Commission, Apportionment of the Common Consolidated Corporate Tax

$$\text{Share A} = \left( \frac{1}{3} \frac{\text{Sales}^A}{\text{Sales}^{\text{Group}}} + \frac{1}{3} \left( \frac{1}{2} \frac{\text{Payroll}^A}{\text{Payroll}^{\text{Group}}} + \frac{1}{2} \frac{\text{No of employees}^A}{\text{No of employees}^{\text{Group}}} \right) + \frac{1}{3} \frac{\text{Assets}^A}{\text{Assets}^{\text{Group}}} \right) * \text{Con'd Tax Base}$$

Base<sup>97</sup>.

EU's approach to be effective, it must be executed from both directive perspectives. CCCTB in this case allocates the share of the PE impact in business structure, thus, how much of the profits may be allocated to the particular structure, taking into account whole structure of business and not merely taking into account the profits of the particular enterprise, which in some cases may be shell company with intellectual property and no employees and other assets created for tax planning purposes (see table 5.). Nonetheless, for effective application also to digital enterprises, the nexus rules must be recreated, either as it is mentioned in Digital Significance Directive or otherwise. G. Cottani, speaking on the question of how from his point of view new nexus should be created, mentioned that to certain extent he believes that CCCTB in a way balances out each jurisdictions contribution to the origin of wealth, thus allocation of rights could also be fair to all, moreover, such system would be predictable and simple, reaching higher level of certainty.

Table 5. –European Commission, “Luxembourg’s selective tax benefits to Amazon are Illegal”<sup>98</sup>



Also, similarly to Israel's and India's approach, EU constructing its nexus rules are placing focus on threshold of revenues and user participation. Seemingly it must be evaluated,

[https://ec.europa.eu/taxation\\_customs/sites/taxation/files/proposal\\_significant\\_digital\\_presence\\_21032018\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf), accessed: 25.04.2020

<sup>97</sup> Supra note 96

<sup>98</sup> European Commission, “Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in Netherlands are illegal under EU state aid rules,” *Press release* (2015). Available: [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_15\\_5880](https://ec.europa.eu/commission/presscorner/detail/en/IP_15_5880), accessed : 26.04.2020

whether the thresholds stipulated in the EU proposal on Significant Digital Presence are appropriate to distinguish the real effect on the economy, since as it does not in either way tackle on the markets size, thus it is not clear whether such rules would not be discriminatory towards small economies, where companies might not reach the digital significant presence only due to the fact that, market size is limited to such extent. On the same ground, Mr. Cottani, opposed that amount of users would not in all cases create legitimate results, due to the fact that one person may own several accounts, thus accounting for more than one user.

### **3.2. Critical Analysis and Proposals for Ongoing Work of the New Nexus Development on Global Scale**

As it can be seen, the development of the new nexus is happening on the international level through OECD Inclusive Framework and BEPS action plans, European Union level through directives and also through domestic laws of the countries. All approaches to certain extent correlates to each other, from the perspective of determining what shall be understood as significant presence in the economy, without substantial physical presence. Approaches of domestic laws, Amount A of OECD's plan and EU's Digital Significant Presence Directive, includes two main areas which are overlapping in all three cases. It is threshold for revenues and threshold for amount of users to determine the new nexus. Nonetheless, each approach creates certain issue, which must be evaluated regarding the level of thresholds, overall application, possible transitional issues and arising compliance costs, before enacting the internationally standardized rules for the new nexus rules for digital economy, taking also into account possible effect on regular businesses and real economy.

#### **3.2.1.1. Current PE system must be revised before creation of new nexus**

New nexus so far as discussed by OECD, will be built as new set of rules, which thus also will go in line with current PE rules<sup>99</sup>. One of the concerns of MNE's<sup>100</sup> and also agreed and supported by Giammarco Cottani, is that current rules, has left too much discretion to tax authorities. Also it can be seen in the recent cases of *Dell Spain*, *Zimmer* and *Dell Norway*, which has shown that tax authorities are seeking to apply PE concept beyond its internationally agreed approach<sup>101</sup>, referring to practical circumstances, thus resulting in business environment without predictable grounds. Mr. Cottani on this topic continued with concerns of creating new nexus system on not fully certain and developed current system, could consequently result in even more unpredictable and uncertain political and legal environment.

Nonetheless, OECD under Action 7. (*Preventing the Artificial Avoidance of Permanent Establishment Status*)<sup>102</sup>, tackles on common strategies preventing PE application. These strategies mainly refers to commissioner agreements between related persons and

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<sup>99</sup> Supra 56, p. 22

<sup>100</sup> PwC, Permanent Establishment 2.0 At the heart of the matter, (2013), available on: <https://www.pwc.com/gx/en/tax/publications/assets/pwc-permanent-establishments-at-the-heart-of-the-matter-final.pdf>, accessed: 27.04.2020

<sup>101</sup> Supra 79, p. 10

<sup>102</sup> OECD, Preventing Artificial Avoidance of Permanent Establishment Status Action 7 – 2015 Final Report, *OECD Publishing*, (2015), Paris, available on: <https://www.oecd-ilibrary.org/docserver/9789264241220-en.pdf?expires=1588016597&id=id&accname=guest&checksum=E259D028A8FE2ACC1AD9FCA9EA3F25C2>, accessed: 27.04.2020

intentional fragmentation of the companies to be regarded as auxiliary or preparatory activity, which previously were not covered by OECD Model Tax Convention<sup>103</sup>. However, it does not in any way cover digital enterprises or artificial application of PE principle to be bound by specific CIT rules. Moreover, rules proposed and also implemented through MLI, currently has only been enacted by half of the contracting states and yet, they only solves particular consequences arising from previous application. Seemingly, the level of discretion left to countries, still is not the topic covered. The general issue, with this regards, is high subjectivity left applying main definition<sup>104</sup>, thus leading to ability to determine PE on the grounds of de facto. First and foremost, to create effective system, where new nexus rules would be built upon PE concept, it would ask for even greater changes, where particular thresholds are determined also for PE concept to grant uniformly equal system worldwide. If such action will not be taken before creating new nexus, the uncertainty and complexity of rules would only increase, thus following with economic investment downturns, taking into account the fact that effective tax rate of profits is third most important factor for investment and location decision<sup>105</sup>.

### 3.2.1.2. Systematic approach of the new nexus and threshold level to reach objective significant presence

As noted above, threshold levels are still the topic of discussion under OECD approach under Amount A. The work done so far, regarding OECD, does not lead to directions, on which possibly new nexus rules could be based. As far as it is developed, EU's Significant Digital Presence Directive's proposal is the one, which could possibly also reflect in OECD approach. Thus, for the sake of evaluation and creation of hypothetical end scenario, author assumes that this approach also will be adopted in the OECD's approach. Thus, company would be regarded as having significant digital presence in case if:

“(a) the proportion of **total revenues obtained in that tax period** and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds **EUR 7 000 000**;

(b) the **number of users** of one or more of those digital services who are located in that Member State **in that tax period exceeds 100 000**;

(c) **the number of business contracts** for the supply of any such digital service that are concluded in that tax period by users located in that Member State **exceeds 3 000**.”<sup>106</sup>

Similarly, as far as scholars<sup>107</sup> and tax advisory group<sup>108</sup> has tackled possible development of new nexus, the ideas have circulated around such approach. Thus, it could be assumed that

<sup>103</sup> Supra note 103, p. 11

<sup>104</sup> PwC, Implications of the new permanent establishment definition on retail and consumer multinationals, *Transfer Pricing Perspectives: The new normal: full TransParency*, (Germany, 2015), available on: <https://www.pwc.com/gx/en/tax/publications/transfer-pricing/perspectives/assets/tp-16-implications.pdf>, accessed: 27.04.2020

<sup>105</sup> E. Zangari, A. Caiumi, T. Hemmelgarn, Tax Uncertainty: Economic Evidence and Policy Responses, *taxation papers*, (2017), available on: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/taxation\\_paper\\_67.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_paper_67.pdf), accessed: 27.04.2020

<sup>106</sup> Supra note 94

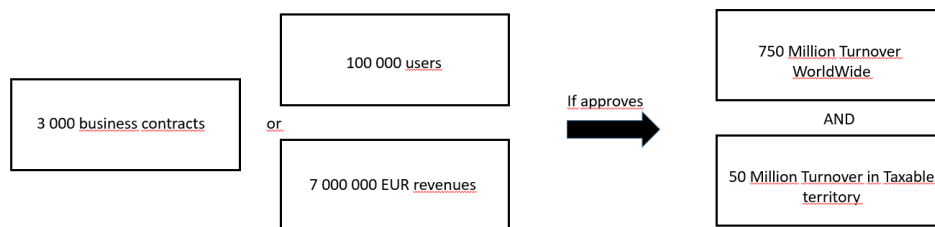
<sup>107</sup> Supra note 56, pp. 25-27

<sup>108</sup> Supra note 54

outcome, would also be based on development of amount of users, business contracts and revenues.

First and foremost, the whole structure of allocating taxing rights to digital presence must work as a complete system, which does not merely take into account either revenues or user amount, since as such application might lead to misleading grounds of application, thus resulting in unnecessary compliance costs, which for MNE's is estimated to be around 3% and on the other hand for SME's up to 30% from the taxes paid yearly<sup>109</sup>, moreover taking into account that such application to certain extent would also overburden tax administrations with cases, without real benefit, thus it would result in increasing costs for governments. EU's approach with this regards, has created package<sup>110</sup>, with certain thresholds for nexus and only creating taxing rights if revenues exceed certain amount (see table 6.), thus consequently excluding situations where, for instance Company A, has 300 000 users country B, but each user pays only 1 EUR for the service, thus only 300 000 EUR revenues yearly. Similarly it is done under Amount A of OECD's application (see table 4.), which creates 6 step test to determine whether there exist liability to Amount A.

Table 6. – A. Zingulis, EU's package of application the significance presence<sup>111</sup>



Nonetheless, two main issue question can be drawn from both approaches, regarding setting threshold level, which is rather confusing test currently made by the EU and to certain extent also by OECD, which has set threshold level in terms of numbers, not percentage. Meaning that, threshold levels in exact numbers, does not in any way reflect upon market size and population of the particular market. In particular, comparing small economies to big economies, such as Latvia and France, results create doubtful situation from the perspective of 100 000 users as being regarded as significant digital presence in all markets equally. Taking data from 2019 of internet usage percentage by individuals from whole population, Latvia had 87 percent and France had 91 percent<sup>112</sup>. In 2019, Latvia's population was 1 919 968, while France's population accounted for 67 012 883<sup>113</sup>. Therefore internet users in Latvia accounts approximately for 1 670 372 people, while France has 60 981 723 internet users (see Table. 7). Taking into account SDP Directives user amount, which was 100 000 users, it would mean that if company covers five percent of Latvia's users, it shall be regarded as having significant digital presence, while on the other hand, in France it would account for 0.1 percent of the whole internet user base.

<sup>109</sup> Supra note 92, p. 8

<sup>110</sup> European Commission, "Fair Taxation of the Digital Economy", (2018), available on: [https://ec.europa.eu/taxation\\_customs/business/company-tax/fair-taxation-digital-economy\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en), accessed: 28.04.2020

<sup>111</sup> Authors made graph according to European Commission proposals.

<sup>112</sup> Eurostat, Individuals – internet use, (2020), available on: [https://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=isoc\\_ci\\_ifp\\_iu&lang=en](https://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=isoc_ci_ifp_iu&lang=en), accessed on: 28.04.2020

<sup>113</sup> European Union, EU in Figures, *about EU*, (2020), available on: [https://europa.eu/european-union/about-eu/figures/living\\_en](https://europa.eu/european-union/about-eu/figures/living_en), accessed: 29.04.2020

If taking look back on previously covered benefit theory and economic allegiance theory developed by Thomas Sewall Adams, such situation would create situation where, for instance, Latvia would have to incur five percent of costs for the government to overall market situation, while France would only need to incur 0.1 percent, to have a rise of taxing rights on the grounds of significant digital presence, not even taking smaller markets and economies as Latvia. Thus, possibly breaching one of the fundamental principles of international taxation – Fairness. Author, with this regards, thinks that OECD discussing approach of new nexus rules under Amount A, should take into account and reevaluate, what should be regarded as significant economic presence in percentage terms and it should reflect upon threshold development, also with respect to turnovers, since as in certain markets, it would simply be impossible to reach threshold of 750 Million EUR, due to the size of the market.

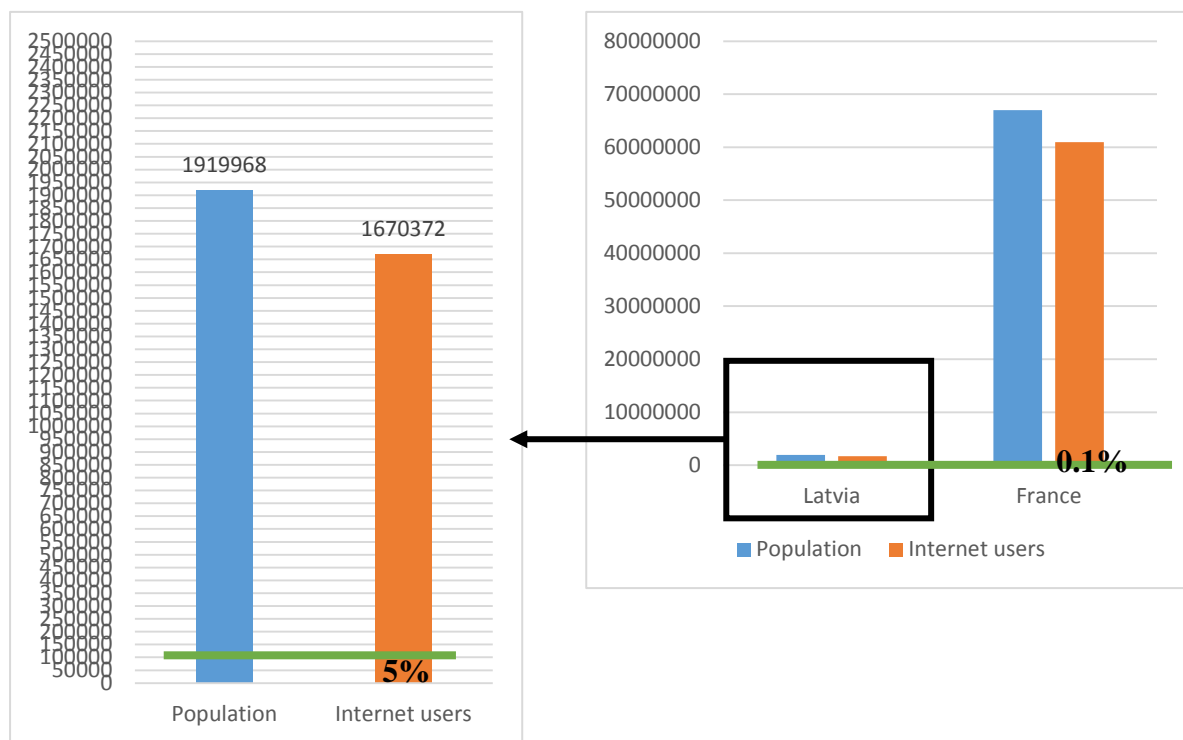


Table 7. – A.Zingulis, Internet user amount to population of France and Latvia<sup>114</sup>

### 3.2.1.3. Current administrative system limits scope of new nexus only to MNE's

To continue, as far as Amount A, currently has been developed, it is proposed to be applicable to enterprises with 750 Million EUR turnover in particular financial year<sup>115</sup>. Such detailed targeting is argued to be sufficient, not to overburden SME's and also tax administrations, due to the fact that compliance costs also for SME's is ten times bigger than MNE's, which is 30 percent increase<sup>116</sup> for tax payers administrative burden in case of application of the new

<sup>114</sup> Authors made table, based on Eurostat data and calculations

<sup>115</sup> Supra note 83, p. 12

<sup>116</sup> Supra note 94, p. 8



nexus rules, thus not creating effective and reasonable grounds for implementation also for wider scope of businesses<sup>117</sup>.

Nonetheless, it must be understood that, SME's influence on overall OECD country economy, accounts for 95 percent companies and also generates up to 60-70 percent employment<sup>118</sup>. Also important factor is that on average 63 percent<sup>119</sup> of the total taxable business profits worldwide is a contribution from SME's. Moreover, based on OECD's findings in 2016, average CIT revenue share from overall income from taxation, accounts for approximately 13 percent<sup>120</sup>, which thus would mean that current rules would not in any way cover consequently approximately 8 percent of all CIT revenues. Moreover, 750 EUR million revenues are only generated by Mega Multinational Enterprises, while also from the application Large Multinational Enterprises (hereinafter, referred to as "LME having revenues in the range of 50 million to 750 million") would be excluded, which could also play important role in the economy.

However, as far as it is considered, excluding SME's and LME's from new nexus application is based on unnecessary and unreasonable administrative burden for tax payers and tax administration. Thus, it would be a fundamental question of how to systemize, automatize and digitalize processes, to reduce this burden. Also, simply by excluding SME's and LME's, governments do not fully solve the issues arising from digitalization of the economy. Nonetheless, it must be said, that this also has been recognized on the OECD and G20 level endorsing the move to a new global standards for automatic information exchange<sup>121</sup>.

#### **3.2.1.4. Interim measure possible negative effects on the real economy**

Last and relatively important factor is the possible consequences arising from situation where countries are implementing domestic measures. Israel's and India's cases in comparison with OECD's developed Amount A application in table 4, rises and creates certain issues, which were covered already by Peter Hongler and Pasquale Pistone, stating that there must be some sort of instrument or mechanism, which would exclude situations where new rules conflicts with already existing international standards, thus resulting in double taxation<sup>122</sup>. From the India's perspective, it can be seen that to ensure compliance with already existing international norms, they have mentioned an exclusion in case of overlapping rules. On the other hand, Israel does not have such compliance clause and also the third point of the article, creates situation with low standards under which digital enterprises could fall under without taking any significant and direct action, also taking into account the fact that there is no permanency needed. Also both cases in question, does not take into account any overall economic status of the company, thus it could possibly result in situation where also loss-making companies

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<sup>117</sup> Supra note 83

<sup>118</sup> OECD, "Small and Medium-sized Enterprises: Local Strength", Global Reach, *policy brief*, (2000), available on: <http://www.oecd.org/cfe/leed/1918307.pdf>, accessed: 29.04.2020

<sup>119</sup> OECD, "Taxation of SMEs in OECD and G20 countries", *OECD Tax Policy Studies*, (2015), Paris, available on: [https://read.oecd-ilibrary.org/taxation/taxation-of-smes-in-oecd-and-g20-countries\\_9789264243507-en#page3](https://read.oecd-ilibrary.org/taxation/taxation-of-smes-in-oecd-and-g20-countries_9789264243507-en#page3), accessed: 29.04.2020

<sup>120</sup> OECD, "Corporate Tax Statistics", *First Edition*, (2019), Paris, available on: <https://www.oecd.org/tax/tax-policy/corporate-tax-statistics-database-first-edition.pdf>, accessed: 29.04.2020

<sup>121</sup> Infra 126, p. 2

<sup>122</sup> Supra note 56, p. 26

would either be taxed or the administrative burden of the compliance with rules would result in even higher expenditures for companies<sup>123 124</sup>.

Possible arising consequences with respect to interim measures on country-by-country basis, was also one of the main concerns of OECD, 2018 report on Tax Challenges Arising from Digitalisation<sup>125</sup>. Previous two cases also supports from the practical perspective, that it may lead to adverse effect, in case of completely or partly different rules domestically. Thus, that's the main reason why there must be uniformly agreed global solution and system, which would equally reflect on taxpayer and tax authority, mainly to avoid creating significant compliance costs, and to avoid fragmentation and mayor differences among countries<sup>126</sup>. In case of not reaching the consensus based solution, it would possibly reach negative effect on the market, with regards to, lowering investment, innovation and growth, since as interim measures would result in increase of cost of capital, thus reducing incentive to enter the new markets. This would negatively affect not only the new market, but also reduce outputs and inputs in domestic market, resulting in decline of production at residence state<sup>127</sup>. Moreover, industries with high price sensitivity<sup>128</sup> would also suffer, meaning that particular interim measure would increase the price, thus if the particular product in question is more of a functional value based product, then even small increase in price, could possibly lead to consumer or business switching to other producer<sup>129</sup>. Lastly, as it was already mentioned previously, compliance costs and over-taxation is another issue, which could possibly arise because of Interim measures<sup>130</sup>.

Understanding possible arising consequences regarding digital presence not being agreed on International forum with regards to common system. It could be even more harmful, than not enacting new rules. Market access to worldwide would significantly be limited, thus lowering growth options, declining production, increasing costs and so. This would also reflect to the consumer access to products and welfare in general terms. Taking into account this, it has to be concluded that to reach fair, effective and promoting environment where both, governments and businesses benefit, could only be attained at international level, with equally applicable system, which would solve the issue questions, not domestic law actions, regardless of the content<sup>131</sup>. Referring also back to Grace Perez-Navarro, who is Deputy Director of OECD Centre for Tax Policy and Administration:

“No single country alone can tackle these issues effectively. In the absence of coordinated efforts, these activities will simply shift from country to country, making

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<sup>123</sup> Supra note 56, p. 27

<sup>124</sup> Supra note 56, p. 27

<sup>125</sup> OECD, “Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS”, *OECD/G20 Base Erosion and Profit Shifting Project*, (2018), Paris. <http://dx.doi.org/10.1787/9789264293083-en>, accessed: 24.04.2020

<sup>126</sup> Supra note 56, p. 29

<sup>127</sup> Supra note 90, p. 180

<sup>128</sup> Abdullah-Al-Mamun, M. Khalilur Rahman, S. D. Robel, “A Critical Review of Consumers Sensitivity to Price: Managerial and Theoretical Issues”, *Journal of International Business and Economics*, (2014), available on: [http://jibe-net.com/journals/jibe/Vol\\_2\\_No\\_2\\_June\\_2014/1.pdf](http://jibe-net.com/journals/jibe/Vol_2_No_2_June_2014/1.pdf), accessed: 24.04.2020

<sup>129</sup> Supra note 90, p. 179

<sup>130</sup> Supra note 90, p. 179

<sup>131</sup> Y. Brauner, “BEPS: An Interim Evaluation”, *World Tax Journal*, (2014), available at: <https://www.ibfd.org/sites/ibfd.org/files/content/pdf/WTJ-Free-Article-March-2015-Newsletter.pdf>, accessed: 27.04.2020

it harder for countries to implement their desired tax policies in an effective manner.”<sup>132</sup>

## Conclusions

The purpose of this thesis was to understand how permanent establishment principle takes care of digital economies profit taxation, mainly through current and upcoming approaches. The paper, placed focus on how permanent establishment principle has developed, and what theories and economic purpose is in the core of the principle, to understand objective grounds of its application to business profit taxation. Furthermore, as of the application of current PE principle, it was acknowledged, that it still is closely tied with historical approach, which is connected to significant physical presence within particular jurisdiction. Nonetheless, with the rise of the digital economy, it was concluded that there is no need of physical presence to have a substantial economic presence, thus current rules to certain extent are not able to fairly allocate taxing rights based on the origin of wealth.

Application of current permanent establishment principle from the perspective of practical case law examples and commentaries of the OECD Model Tax Convention and UN Double Taxation Convention, clarified three main ways of PE application to digital enterprises. First way of application is through furnishing services for at least 6 month period in any 12 month period, second way is through fixed place of business if enterprise has its servers on which website is hosted with permanent character and it must be maintained by personnel, third way of application is through dependent agent clause, which must be at the disposal of enterprise, having ability to conclude contracts in the name of the enterprise.

Such application leaves gaps and unanswered question, which might be used by digital enterprises either to be bound or to avoid application of the PE and also used by tax authorities to widen application of PE and go beyond the real purpose of the principle. This consequently creates issues for both sides, tax payer and tax authorities. Tax payers are able to intentionally use current application of PE to establish it in low-tax jurisdictions, resulting in lowering corporate tax burden, while this means that high-tax jurisdictions, where the company is resident, thus loses tax revenues from supposedly collected CIT. On the opposite, case law has also shown, that tax authorities in certain situations are applying the PE where others would not – Case of Dell Spain v. Spain. Thus leading to situation where tax payer cannot be certain about the legal grounds and rules, consequently resulting as a barrier for growth promoting business environment, also argued and supported in the interview conducted with Giammarco Cottani, the tax policy director of the company Netflix. On the same hand, current rules are not taking into account demand factor of the origin of wealth, thus not allocating any rights to market jurisdiction without PE.

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<sup>132</sup> OECD, “Restoring Fairness to the International Tax System”, (2013), available on: <https://www.hse.ru/data/2013/09/05/1276980799/Grace%20Perez-Navarro%20Restoring%20Fairness%20Moscow%20SpeechI.pdf>, accessed: 28.04.2020

Nonetheless, the need for nexus rules and changes in the current PE principle, has been acknowledged in 2011, by the European Commission proposals for Council Directives for CCCTB, SDP and DST. Moreover, in 2013, also on the international level when the OECD/G20 developed BEPS action plans and report *Addressing Tax Challenges Arising from Digitalization*. New nexus rules supposedly are developed through inclusive framework instrument, under pillar one. Conceptually as far as it has been currently developed, it will be six step test to have the liability towards market state (Amount A test), which will only be applicable to companies exceeding 750 million EUR, nonetheless the new nexus test, which is last test, still has not been formulated. Due to this fact, author looked upon EU proposals under DSP directive and Israel's and India's significant economic presence rules and draw possible outcomes to new nexus test.

Despite the limitations and uncertainty of the real possible outcome, the analysis led to four conclusions, which must be taken into account developing ongoing rules. Firstly, current PE system has left too much discretion to states and it creates uncertainty on country-by-country basis. If new nexus will be built in-line with current PE rules, then there is a need for greater changes not to consequently lead to even higher uncertainty. Secondly, threshold test should not be made in exact numbers, since as it does not take into account variety of market sizes, which thus could result in unfair application, even if all market would be covered, but threshold would still not be reached. Thirdly, application to MNE's is solely due to administrative burden and compliance costs, which means that more than half of the economy, including SME's and LME's will not be covered. Therefore it is not complete solution to combat issues arising from digital economy. Lastly, no single country alone can combat the arising issues, it is global problem and it asks for global solution. Interim measures would only result in higher uncertainty affecting economic growth.

Taking into account all research done so far and still unknown factual circumstances, author has developed four **recommendations** for further development of the topic:

- 1) Analysis of actual new nexus rules, which are proposed to be agreed in the end of 2020 by OECD Inclusive Framework under Pillar One. Outcome comparison with findings of thesis.
- 2) How court practice currently limits PE application in avoidance cases or intentional application of PE under Article 29 of OECD Model Tax Convention, which sets out the general rule of not benefiting from rules if all circumstances, allows to reasonably conclude that obtaining benefit is the only principal purpose of the activity?
- 3) The necessary measures to create effective administrative system for country-by-country reporting and also to reduce compliance costs for the SME's and LME's to be bound by the new nexus.
- 4) How should the value brought by customer be applied to the value chain and origin of wealth principle, to sufficiently balance out the economic allegiance between involved supply and demand (market) jurisdictions?

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## **Annex. 1 – Interview Questions**

Author conducted telephone interview with Giammarco Cottani, Tax Policy Director of company Netflix and international tax law researcher in IBFD, also delegated to represent Italy in OECD BEPS plan development, and the following question were discussed:

If we assume that OECD/G20 countries agrees on changes under Pillar One on the new nexus rules and taxing allocation rights by the end of the 2020, and assumption within this regards would be that it would follow similar approach as EU proposed under its Significant Digital Presence Directive, that the main factors for the New nexus rules would be –

- a. if the revenues from providing digital services to users in a jurisdiction exceed EUR 7 000 000 in a tax period,
- b. if the number of users of a digital service in a Member State exceeds 100 000 in a tax period or
- c. if the number of business contracts for digital services exceeds 3 000.

Thus if reaching threshold, countries to which business is non-resident would have the taxing rights on the profits attributed to the significant digital presence in particular market jurisdiction.

- 1) First and foremost, are there any existing issues with current Permanent Establishment system which you have observed or have experienced?
- 2) What in overall sense you think about the idea of digital significant presence supplementing PE definition? If possible I would like to know your standpoint from both governmental and business perspective. Would you agree that market jurisdiction should have some sort of taxing rights on business profits derived from their jurisdiction?
- 3) What are your main concerns from the business perspective? Also do you think it is fair and not discriminatory from the standpoint that only Large Multinational Companies are covered?
- 4) What solutions do you see for your concerns? Either is it simplified and unified accounting standards, unified systems also with regards to the accounting/reporting or any other option, which you think could help digital businesses and/or governments for the particular concern in question?
- 5) What discussions on what topics OECD working group 1, which is responsible for the development of the new nexus rules, also should take into account before enacting such rules? To guide you, it could give a rise to new issues also in different fields, which would increase work load for the companies, because so far the discussions has circulated around administrative burden of tax authorities, not the businesses.